

Report No. 1396

NEW YORK STATE BAR ASSOCIATION TAX SECTION

**REPORT ON PROVISIONS OF THE NEW TAX LAW
AFFECTING TAX-EXEMPT ORGANIZATIONS**

June 7, 2018

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I. Introduction

This Report¹ addresses certain provisions of “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” P.L. 115-97 (the “Act”) that affect exempt organizations and notes areas where interpretive guidance from the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) is needed. This Report makes recommendations for guidance for certain of the new provisions and suggests alternative approaches for guidance for other provisions.

The Act includes various provisions directly affecting specified exempt organizations.² The Act also contains numerous provisions that have an impact on exempt organizations (including, for example, changes in tax rates) as well as certain provisions that change, or otherwise affect, incentives for charitable giving. Except for certain international provisions, this Report does not address the Act’s provisions of general applicability that also impact exempt organizations, including those provisions affecting incentives for charitable giving.³

A. Siloing of Losses for Purposes of Calculating UBIT

Several provisions of the new law affect how unrelated business taxable income (“UBTI”) is subject to unrelated business income tax (“UBIT”).⁴ New Section 512(a)(6)

¹The principal drafter of this Report is Richard R. Upton, with substantial contributions from Michael Cooney, Joshua Gewolb, Stuart Rosow, Tiffany Tam and Douglas Tang. Helpful comments were received from Kimberly Blanchard, Stephen Land, Michael Schler and Karen Gilbreath Sowell. This Report reflects solely the view of the Tax Section of the New York State Bar Association (“NYSBA”) and not those of the NYSBA Executive Committee or the House of Delegates.

²The new law (as amended by the Bipartisan Budget Act of 2018, P.L. 115-123) exempts from the penalty taxes imposed on a private foundation’s excess business holdings certain 100% holdings of a business enterprise where the profits of such business are distributed to the private foundation and used for charitable purposes. This Report does not address this provision which affects only a very limited number of organizations.

³Various provisions of the Act affect incentives to charitable giving. The Act (1) increases the standard deduction to \$24,000 for joint filers (and surviving spouses), \$18,000 for head-of-household filers, and \$12,000 for individual filers, (2) increases the limits on deductions of cash contributions to public charities and certain private foundations from 50% of the donor’s contribution base (generally, adjusted gross income) to 60% of the contribution base, (3) doubles the gift, estate and generation skipping tax exemption amounts to \$11.18 million for individuals for 2018 and subsequent years (adjusted for inflation), (4) changes how charitable contributions of \$250 or more are substantiated, (5) changes how deductions for charitable contributions are calculated by electing small business trusts with respect to S corporation contributions to public charities, etc., and (6) eliminates a provision that permitted a deduction for 80% of contributions that provided the donor with rights to preferential seating arrangement at college sports events.

⁴Tax-exempt organizations are subject to tax on their UBTI by operation of Sections 511 through 513. The starting point for determining UBTI is the gross income derived from any trade or business activity that is regularly carried on by the organization and that is not substantially related to

provides that in calculating UBTI for taxable years beginning after December 31, 2017, the income and losses from each of an exempt organization's trades or businesses must be separately calculated.⁵ Losses from one trade or business cannot be used to offset income or gains from another unrelated trade or business. Rather, losses from a trade or business only can be carried forward and used to offset UBTI from that same trade or business.

B. Treatment of Certain Fringe Benefits as UBTI

New Section 512(a)(7) provides that, beginning January 1, 2018, the amount of certain fringe benefits provided by a tax-exempt employer will be included in the tax-exempt organization's UBTI. The amount treated as UBTI is the amount of certain fringe benefits for which a deduction would be disallowed under Section 274 if the organization were a taxable employer. Fringe benefits giving rise to UBTI are qualified transportation fringe benefits, possibly including any parking facility used in connection with qualified parking. In what appears to be a drafting error, Section 512(a)(7) lists on-premises athletic facilities as giving rise to UBTI. However, Section 274 as amended by the Act does not include on-premises athletic facilities as one of the fringe benefits for which no deduction is available.

C. Impact of Certain International Provisions

Questions have been raised concerning the proper application to tax-exempt organizations of several of the international provisions of the Act. New Section 965 imposes a

the organization's exempt purposes. For this purpose, an exempt organization is treated as carrying on any trade or business carried on by a partnership of which the exempt organization is a partner. *See* Section 512(c)(1) and Treas. Reg. § 1.512(c)-1. Allowable deductions directly connected with the business are then subtracted from this gross income amount, before relevant modifications are applied. The modifications specifically include or exclude various items of income and related deductions from UBTI. Under these modifications, passive income is generally exempt from UBTI, including dividends, interest, payments with respect to securities loans, loan commitment fees, annuities, royalties, rents from real property, and capital gains. However, even otherwise exempt income will generally be treated as UBTI if it is from debt-financed property or an S corporation stock of which is owned by an exempt organization. *See* Sections 512(b)(4), 512(e) and 514.

Once the amount of UBTI is determined, slightly different tax computation rules apply, depending on whether the organization is a charitable corporation or a charitable trust. UBTI is taxed to charitable corporations at the flat maximum statutory corporate tax rate of 21% under the Act. Note that for years prior to the Act, UBIT was imposed at graduated rates ranging from 15% (for organizations with UBTI of \$50,000 or under) to 35% (for organizations with UBTI exceeding \$10 million), so while taxpayers in most brackets received a rate reduction, taxpayers in the lowest 15% bracket actually face a 40% rate *increase*. Treas. Reg. § 1.511-1. In comparison to the taxation of charitable corporations, the UBTI of charitable trusts is taxed at graduated ordinary estate and trust income rates of up to 37% under the Act.

⁵Unless otherwise stated, all "Code" and "Section" references are to the Internal Revenue Code of 1986, as amended.

one-time transition tax on the undistributed offshore earnings of specified foreign corporations by requiring U.S. shareholders to include their pro rata share of such amounts in their income under the Subpart F regime (the “Section 965 Transition Tax”).⁶ The Act also requires global intangible low-taxed income (“GILTI”), as determined under new Section 951A, to be included in the income of a person that is a U.S. shareholder of a controlled foreign corporation (“CFC”).⁷

At issue is whether the earnings deemed repatriated under Section 965 to U.S. shareholders of CFCs should be treated as investment income subject to the 1% or 2% excise tax on net investment income under Section 4940. A similar issue arises with respect to whether GILTI is subject to the Section 4940 tax or the new 1.4% excise tax on the net investment income of certain colleges and universities under Section 4968. Tax-exempt organizations that are U.S. shareholders of CFCs also face the question of whether GILTI should be treated as UBTI.

D. 21% Excise Tax on Compensation Over \$1 Million

New Section 4960 imposes a 21% excise tax on remuneration in excess of \$1 million per year paid to a covered employee by an applicable tax-exempt organization. A 21% excise tax also applies to certain payments contingent on a covered employee’s separation from employment, where the value of the payments exceeds three times the covered employee’s average compensation for the prior five years (so called “excess parachute payments”). The new provision applies to tax years beginning after December 31, 2017.

In general, a covered employee is an employee (including any former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for the taxable year or was a covered employee of the

⁶See NYSBA Tax Section, “Report on Section 965”, Report No. 1388, February 6, 2018.

⁷See NYSBA Tax Section, “Report on the GILTI Provisions of the Code”, Report No. 139, May 4, 2018.

organization for any preceding taxable year beginning after December 31, 2016. An applicable tax-exempt organization is an organization exempt from tax under Section 501(a), an exempt farmers' cooperative and a federal, certain quasi-governmental entities with excludible income or a political organization. Compensation paid by the employer and certain related entities is aggregated in determining the excise tax.

E. 1.4% Excise Tax on the Investment Income of Certain College and Universities

New Section 4968 imposes a 1.4% excise tax on the net investment income of private colleges and universities that have at least 500 tuition-paying students, more than 50% of whom are located in the United States, and assets (other than assets used directly in carrying out the institution's educational purposes) of at least \$500,000 per student. Net investment income is determined under rules similar to the rules of Section 4940(c) concerning the calculation of the 1% or 2% excise tax on the net investment income of certain private foundations. In determining the tax, colleges and universities must include the net income and assets of related organizations. The new provision applies to tax years beginning after December 31, 2017.

II. Summary of Proposed Recommendations and Requests for Guidance

A. Siloing of Losses for Purposes of Calculating UBIT

a. Principal Recommendations

1. We recommend that Treasury and the IRS issue guidance treating investing as one unrelated trade or business with its own silo and allowing UBTI from investments to be reported on an aggregate basis. For this purpose, holdings of partnership interests would be treated as an investment activity so long as the organization (and its related parties) do not control the partnership or own a significant percentage interest in the partnership.

2. In general, we recommend that guidance for determining what is an unrelated

trade or business, where various activities are owned, operated and controlled by the organization, be based on the conceptual underpinnings of the passive activity loss rules and hobby loss rules. Specifically, guidance should provide that an exempt organization can aggregate its controlled trades or businesses using any reasonable method as under the Section 469 regulations. Further, the use of broad categories based on a facts and circumstances test should be sanctioned.

b. Other Recommendations

3. Expenses that do not relate to specific trades or businesses (*i.e.*, administrative staff overhead, office expense, tax preparation fees) should be allocated among categories on any reasonable basis.

4. Fringe benefits giving rise to UBTI should be treated as arising out of an activity that relates to the activity of the organization's employees giving rise to the fringe benefits.

5. Payments from a controlled entity that are UBTI under Section 512(b)(13) should be treated as arising out of the activity of the controlled entity.

6. S corporation flow-through income and gains from the sale of S corporation stock that is deemed to be UBTI regardless of the nature of activity should be part of investment activities if the organization does not control the S corporation. However, if the S corporation is a controlled entity engaged in a trade or business, the S corporation UBTI should be associated with that trade or business.

7. Debt-financed income that arises from investment activities should be aggregated with other investment assets. However, if the debt-financed income arises from an active trade or business that the organization operates and controls, then it should be in its own silo (subject to grouping with similar businesses).

8. Section 512(b)(17) provides that, if an exempt organization is a U.S. shareholder of a CFC, UBTI includes the organization's Subpart F income to the extent attributable to insurance income as defined in Section 953. In our view, all Section 512(b)(17) income should be aggregated and put in its own silo.

9. Guidance should address the circumstance where an activity with losses resumes after having ceased to be conducted for a period of time. We believe that carryforward of these losses should be permitted without limitation.

B. Treatment of Certain Fringe Benefits as UBTI

With respect to the treatment of certain fringe benefits as UBTI under Section 512(a)(7), we make the following recommendations:

1. Guidance should clarify that qualified transportation fringe benefits under Section 132(f) that are funded by employee salary reduction arrangements constitute amounts that are "paid or incurred" by a tax-exempt organization and, therefore, subject to Section 512(a)(7).

2. Relief is requested to avoid a double tax cost to tax-exempt organizations in cases where its employees work on an unrelated business, since the organization could both lose a deduction against UBTI for qualified transportation fringe benefits under Section 274(a)(4) and have an increase in UBTI for the same fringe benefits under Section 512(a)(7).

3. Guidance is needed to clarify the meaning of the language "parking facilities used in connection with qualified parking" under Section 512(a)(7).

4. Guidance is requested as to the manner in which UBTI should be calculated by a tax-exempt organization in connection with parking facilities that are generally open to the public and also are used by employees. We recommend that where the parking facility is open to the public and employees without charge, that it not be treated as a qualified transportation fringe.

5. Guidance should confirm that the amount of an organization's UBTI is based on the costs incurred to provide the qualified transportation fringe (not the fair value of the fringe benefit).

6. In the interest of efficient tax administration, consider whether any de minimis exceptions to Section 512(a)(7) should be provided where the increase in UBTI for providing qualified transportation fringe benefits is outweighed by the administrative costs and burden of accounting for such increase.

7. Confirm that the "on premises athletic facility" language in Section 512(a)(7) should be disregarded as a drafting mistake.

C. Impact of Certain International Provisions

1. Guidance is needed to confirm the proper treatment of Subpart F income, including the Section 965 Transition Tax inclusion amount, as applicable, for purposes of the net investment income rules of Sections 4940 and 4968. Such guidance should also indicate the proper timing of inclusion in net investment income, since Subpart F income (including Section 965 inclusions) cannot be taxed both as it arises and when it is distributed by a CFC. Consideration could also be given to allowing tax-exempt organizations to pay the Section 4940 tax on their Section 965 inclusions over 8 years, notwithstanding the fact that such amounts are included in income in the taxable year that begins before January 1, 2018.

2. Guidance should confirm that GILTI inclusion amounts should be subject to the same treatment as Subpart F inclusions (including the Section 965 Transition Tax amount) for purposes of the net investment income rules in Sections 4940 and 4968.

3. Guidance should confirm that, except as provided in Section 512(b)(17) (concerning insurance income), Subpart F income, including Section 965 Transition Tax amounts, are excluded from the definition of UBTI and that GILTI should similarly be excluded.

4. The IRS and Treasury should confirm that Section 965 inclusions are not taxable to tax-exempt organizations under a new regime, but instead are treated consistently with other types of Subpart F income (*i.e.*, taxed only as net investment income but not as UBTI).

D. 21% Excise Tax on Compensation over \$1 Million

1. We request that Treasury and the IRS include a statement in the Section 4960 guidance to the effect that the applicability of the Section 4960 excise tax based on a covered employee's compensation does not create any inference or presumption that the compensation paid is unreasonable or excessive, including for purposes of the self-dealing rules applicable to private foundations under Section 4941 or the excess benefit transaction rules under Section 4958.

2. Guidance is needed on what is an applicable tax-exempt organization. Our reading of the statute is that state colleges and universities, and other organizations that rely on the doctrine of intragovernmental immunity, including states and political subdivisions along with their integral parts, are not applicable tax-exempt organizations. Confirmation of that result is requested, especially in the case of public colleges and universities.

3. Guidance also is requested whether quasi-governmental entities, such as public universities and hospitals, which voluntarily sought and received recognition of their exempt status under Section 501(c)(3), are subject to Section 4960 as a result.

4. Guidance is needed for determining who is a covered employee. Should only the five highest compensated employees of the organization be included, based solely on their compensation from the organization, or should compensation from related organizations be included in determining who is a covered employee? The statute seems to indicate that only compensation paid by the applicable tax-exempt organization should be used in determining who is a covered employee (while remuneration paid by the organization and related organizations is

used in determining the amount of tax payable). However, guidance could provide that remuneration paid by related organizations is included in determining covered employee status, consistent with the approach the Form 990 takes in determining an organization's five highest compensated employees.

5. Should individuals who are among an organization's five highest compensated employees be treated as covered employees, even if their remuneration would not be subject to the 21% excise tax (for example, medical professionals, nonresident alien individuals and ministers)? Here, the statute seems to require the inclusion of medical professionals, etc. as covered employees, even if their remuneration would not be subject to the tax, but the policies behind the statute suggest otherwise.

6. Guidance should provide that, in the case of a fiscal year organization, compensation for purposes of determining who is a covered employee should be based on amounts paid to the employee for the calendar year ending with or within the organization's fiscal year.

7. We recommend that the term "licensed medical professional" be broadly interpreted to include dentists, nurses and others with a state license having a connection to the medical field.

8. A complicated organization which consists legally, for example, of five different exempt organizations seemingly would have up to 25 covered employees in any given year and could be subject to the Section 4960 tax on each of those 25 individuals, while if the same organization were structured as one exempt organization with four or five divisions or disregarded entities, it would have only five covered employees in any given year. Guidance is requested on whether this result is required or whether an approach based on controlled group

rules might be appropriate.

9. Guidance is needed with respect to the meaning of the term “control” and “controlled” in determining which organizations are related organizations. Query whether reference to the controlled group rules under Sections 414(b), (c), (m), and (o) and Treas. Reg. § 1.414(c)-5 is appropriate in this context.

10. We think guidance should be issued providing that even though the remuneration paid by a related for profit or governmental entity generally is taken into account in determining whether the covered employee of the applicable tax-exempt organization has remuneration in excess of \$1 million, the related for profit or governmental entity is not itself liable for any portion of the tax.

11. It would be appropriate for guidance to provide for a “look through” rule for pass through entities (including S corporations, partnerships and limited liability companies), such that amounts paid by an applicable tax-exempt organization (or a related organization) to a pass through entity owned in whole or in part by an employee (or person who would be an employee if paid directly by the organization), would be treated as compensation/remuneration to the individual to the extent of his or her ownership in the entity. Further, regulations could provide that payments to any entity for the services of an individual would be treated as paid to such individual to the extent attributable to such individual’s services.

12. With respect to “parachute payments” under Section 4960(c)(5)(B)(i), we recommend that Treasury and the IRS clarify that a “payment in the nature of compensation” has a meaning similar to the standards under Treas. Reg. § 1.280G-1 and consider providing rules and exceptions for determining parachute payments for Section 4960 purposes similar to the guidance under Treas. Reg. § 1.280G-1 (such as exceptions for vested amounts and reasonable

compensation for personal services).

13. We request that Treasury and the IRS clarify the meaning of “contingent on a separation from employment” in the context of the Section 4960 tax on excess parachute payments.

E. 1.4% Excise Tax on the Investment Income of Certain Colleges and Universities

1. Treasury and the IRS should consider guidance that provides that only students in a degree program who are tuition-paying be included in determining how many students the endowment would be divided among for determining whether the institution has over \$500,000 per student.

2. Guidance is requested on the definition of “tuition-paying” student and whether students who receive full scholarships are not “tuition-paying” and should not be counted for this purpose.

3. Guidance is requested confirming that undergraduate and graduate students count as students.

4. We recommend that guidance be issued that confirms that various assets, in addition to physical facilities, be treated as used directly in carrying out the institution’s exempt purposes, and not included in the determination of whether the institution has \$500,000 in assets per student. Consideration should be given to whether certain restricted endowment funds could qualify as assets used directly in carrying out the school’s exempt purposes. Such assets could include funds set aside for use by the institution for exempt purposes within a relatively short period of time and restricted endowment funds held for a specific scholarship, funds dedicated to funding a professorship, or restricted assets set aside to build a new library or classroom. It is noted that some believe that cash and investment assets (including restricted funds) should not be

excluded from the determination of whether the institution has \$500,000 in assets per student.

5. Guidance is needed to determine what constitutes control for purposes of determining whether an entity is a related organization.

6. In determining whether assets and net investment income of a related organization are available for the use or benefit of the educational institution, we recommend that guidance follow the legislative history's approach that, in general, only income and assets of a related organization that are earmarked or restricted for the educational institution should be attributed to it.

7. In general, assets (and income) of a related organization only should be treated as assets (and income) of the educational institution to the extent of relatedness.

8. Guidance should confirm that the income from assets used directly in carrying out the institution's exempt purposes is subject to the new excise tax.

9. Consideration should be given to interpreting Section 4968 to carve out from investment income amounts from exempt use assets, such as rental income from dormitories and faculty housing, where the assets are not held for investment purposes and are anticipated to produce net losses.

III. Discussion

A. Siloing of Losses for Purposes of Calculating UBTI

1. Overview

Under Section 512 prior to the Act, an exempt organization would determine the amount of its UBTI by aggregating all the gross income from all unrelated trades or businesses and subtracting any applicable deductions from all unrelated trades or businesses. This allowed organizations to apply deductions to an unrelated trade or business that may have arisen in another trade or business to reduce the aggregate amount of unrelated business taxable income.

The Act added the following language as Section 512(a)(6):

In the case of any organization with more than 1 unrelated trade or business—

(A) unrelated business taxable income, including for purposes of determining any net operating loss deduction, shall be computed separately with respect to each such trade or business and without regard to subsection (b)(12),

(B) the unrelated business taxable income of such organization shall be the sum of the unrelated business taxable income so computed with respect to each such trade or business, less a specific deduction under subsection (b)(12), and

(C) for purposes of subparagraph (B), unrelated business taxable income with respect to any such trade or business shall not be less than zero.

The result of this new language is that exempt organizations are no longer able to use a deduction or loss from one trade or business to offset the income or gain from a different unrelated trade or business (the “Siloing Rule”).⁸ (We refer to each trade or business as defined for these purposes as a “category” or “silo.”) A deduction for a net operating loss (“NOL”) will be “allowed only with respect to a trade or business from which the loss arose.”⁹ An organization may, however, use a deduction from an unrelated trade or business in one taxable year to offset income from the same unrelated trade or business in a subsequent year.¹⁰ A transition rule provides that existing NOLs from taxable years beginning prior to January 1, 2018 are not subject to this rule.¹¹

The legislative history provides only limited discussion of this provision. In regard to this provision, the Ways and Means Committee, in its 2014 consideration of a similar proposal, referenced the 2013 Colleges and Universities Compliance Final Report (the “Final Report”), in

⁸H.R. Rep. No. 115-466, at 548 (2017) (Conf. Rep.) (hereinafter, the “Conference Report”).

⁹*Id.* In computing the NOL, Section 512(b)(6) will apply. This section provides that the net operating loss deduction will be determined without taking into account any amount of income or deduction which is excluded in determining UBIT.

¹⁰*Id.* The statute does not address what happens to NOLs following the disposition of the business that gave rise to such NOLs.

¹¹Act Section 13702(b)(2).

which the IRS identified the reasons for adjustments made as part of its examination of compliance by colleges and universities.¹² With respect to UBIT, a significant number of adjustments arose from disallowance of losses and NOLs from activities that were deemed to lack a profit motive as a result of years of losses. It is not entirely clear what types of trades or businesses were deemed to lack a profit motive. Although the Final Report does not include an example of activities deemed to lack a profit motive, it indicates that the most common areas for adjustments generally were fitness, recreation centers and sports camps, advertising, facilities rentals, arenas and golf. New Section 512(a)(6) would appear to be aimed, at least in part, at addressing this perceived abuse.¹³

2. Potential Approaches

The Act does not provide guidance on the critical issue of how to determine a trade or business for purposes of the Siloing Rule. This section first reviews the categories of UBTI, focusing on the dichotomy between business and investment activities, and then examines other provisions of the Code that address similar conceptual issues of determining what constitutes an appropriate separation or aggregation of different business activities. Finally, the Report suggests a set of principles for application in determining the definition of an “unrelated trade or business” for this purpose.

a. Categories of UBTI: Business vs. Investment

The activities that generate UBTI could be viewed conceptually as falling into one of five categories. First are truly active trades or businesses that the organization operates and controls (*e.g.*, sales of merchandise through a shop or store where the merchandise is not related to the

¹²Majority Tax Staff of H. Comm. on Ways and Means, 113th Cong., *Tax Reform Act of 2014, Discussion Draft, Section-by-Section Summary*, at 152 (2014). https://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_050213.pdf

¹³It is unclear why Congress choose a “siloing” approach in drafting Section 512(a)(6), rather than a “hobby loss” approach as in Section 183 or a common law approach that a business with no realistic possibility of operating at a profit is not a business.

organization's exempt purposes, selling advertising for an organization's monthly magazine or a controlling interest in a joint venture that conducts an unrelated business).¹⁴ Second are passive investments that generate UBTI (*e.g.*, investing, where the organization does not have control over the entity it is investing in and where UBTI includes income and gains from debt-financed property). Third are investments in partnerships which give rise to UBTI under Section 512(c) and are deemed active businesses (*e.g.*, investments in partnerships that are engaged in trades or businesses, but where the investor organization has no control over the partnership, such as an investment in a private equity fund, a venture capital fund or a publicly traded partnership engaged in oil and gas extraction or transportation activities). Fourth are payments from controlled entities which are UBTI under Section 512(b)(13). Fifth, as a result of the Act, is UBTI from fringe benefits under Section 512(a)(7).

It is not clear how the Siloing Rule of Section 512(a)(6) should apply to these distinct categories of UBTI. Investment activities can be distinguished from active trade or businesses that the organization operates and controls.¹⁵ In theory, it would be possible for investment income (whether active or passive) to be spread equally across all categories or grouped with like categories. Investments could also be divided into separate categories (*i.e.*, real estate investments versus oil and gas investments). However, as noted, conceptually, investment activity is different from the trade or business activities that are conducted under the direction and control of the exempt organization.¹⁶ Indeed the legislative history discusses "investment income" as distinct from trade or business income in its description of the revenue sources of

¹⁴The most common areas for UBIT adjustments noted in the Final Report all would fall within this category.

¹⁵We note that for individual taxpayers, investment activities do not constitute a trade or business for purposes of Section 162. *Higgins vs. Comm'r*, 312 U.S. 212 (1941). However, most exempt organizations are corporations. In general, for a corporation, any profit oriented activity is considered to be part of a trade or business for which deductions are allowed under Section 162.

¹⁶See *Higgins v. Comm'r*, *supra*.

exempt organizations.¹⁷

In our view, investments that are subject to the Siloing Rule should constitute their own category. We do not believe, however, that each investment should be treated separately or that investments should be divided into separate categories based on investment type. Individual investments all combine to form an overall investment portfolio. From an economic perspective, an organization is (or should be) concerned with overall gain and loss in its investment portfolio, not the performance of any individual investment. The tax treatment should follow these principles. Generally, dividing investments into categories based on investment type ignores the economic interrelationship between all investments in the portfolio and is not required by the statute, as separate investment categories are not different “trades or businesses.”¹⁸ Grouping all investments in one silo would also strike the proper balance with administrability, because: (i) it could be difficult for organizations to differentiate between different types of investments, (ii) a single investment might involve many different underlying activities, and (iii) investments may be through flow through entities for which necessary information for other groupings is unavailable.¹⁹

Investments in partnerships with trades or businesses treated as conducted by the organization under Section 512(c) present a more difficult case. An organization that is a passive, minority investor in a partnership²⁰ views such investments similarly to its routine investments in stocks and bonds. Therefore, we recommend that investments in partnerships

¹⁷Conference Report at 546.

¹⁸We note under Section 469(k) the passive activity loss rules are applied to publicly traded partnerships on an entity-by-entity basis. However, this was intended to address use of these partnerships as tax shelters, which is not a concern here. *See* Senate Finance Committee Report, Revenue Bill of 1987.

¹⁹Consideration should be given to the information required from pass-through investments so that special information does not need to be provided to exempt owners that is not provided to other investors.

²⁰For purposes of this Report, the term partnership includes a limited liability company (“LLC”) or other entity treated as a partnership for tax purposes.

should be aggregated with other investments so long as the exempt organization (or a related person) does not “control” the partnership. We note that determining whether “control” exists may be complex. Control certainly encompasses actual control, for example where the organization is the sole general partner or manager of an investment entity. Control also could be viewed as ownership by the exempt organization of a specified percentage of the investment entity. For example, over 50% ownership could be deemed to be control and less than 20% ownership deemed not to be control. Where the exempt organization owns between 20% and 50% of the investment entity, it could be viewed as having substantial influence over the entity and, accordingly, presumed to be in control, absent a showing that its interest in the investment entity is a routine investment over which it in fact does not have control. As an alternative to this rule, a simple fixed percentage test could be employed that would, for example, simply deem anything below a chosen percentage not to be control. Such a flat percentage test would be similar to the rule for control in the excess business holdings rules for private foundations in Section 4943.

The question then becomes, for trades or businesses that are operated and controlled by the organization, what is a separate trade or business? As discussed below, other sections of the Code address this same issue in related contexts.

b. Other Code Sections

Like the Siloing Rule, the passive activity loss rules limit the use of losses from one activity to offset income and gains from another activity.²¹ For the purpose of the passive activity loss rules, one or more trade or business activities or rental activities may be grouped together and treated as a single activity if the activities constitute an appropriate economic unit

²¹Section 469(c) defines “passive activity” to mean “any activity -- (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate.”

for the measurement of gain or loss for purposes of Section 469.²² Treas. Reg. § 1.469-4(c)(2) sets forth a facts and circumstances test for determining whether activities constitute an appropriate economic unit. Factors given the greatest weight are: (i) similarities and differences in types of trades or businesses; (ii) the extent of common control; (iii) the extent of common ownership; (iv) geographical location; and (v) interdependencies between or among the activities. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. There is no single grouping that is required, but a variety of groupings are possible based on the circumstances.²³ Certain limitations, however, apply with respect to grouping certain activities with others; for example, grouping rental activities with other trade or business activities is limited.²⁴ Once activities are grouped, the taxpayer may not regroup them unless the groupings are clearly inappropriate or a material change in the facts and circumstances makes them so.²⁵ Annual statements of regroupings and other changes are required.²⁶ The Commissioner may also regroup activities to prevent tax avoidance.²⁷

Other areas of the Code contain similar conceptual approaches to determining what activities should be aggregated or kept separate in identifying a trade or business. The regulatory history of the passive activity loss rules references Section 183, relating to hobby losses, as a model. The Section 183 rules address a conceptual issue similar to the issue identified in the Final Report of identifying activities that lack a profit motive and ensuring that losses from these

²²Treas. Reg. § 1.469-4(c)(1).

²³Treas. Reg. § 1.469-4(c)(3).

²⁴Treas. Reg. § 1.469-4(d).

²⁵Treas. Reg. § 1.469-4(e).

²⁶Rev. Proc. 2010-13.

²⁷Treas. Reg. § 1.469-4(f). *See generally*, *Charles Brumbaugh v. Comm’r*, T.C. Memo 2018-40 (grouping of real estate construction activity with charter aircraft activity not appropriate).

activities cannot be used against other income and gains.²⁸ Under Section 183, activities must be segregated or aggregated to determine whether, and to what extent, Section 183 applies to the activity. Treas. Reg. § 1.183-1(d)(1) sets forth a facts and circumstances test for making this determination but articulates the relevant factors differently than the passive activity rules. The factors are as follows: (i) the degree of organizational and economic interrelationship of various undertakings; (ii) the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting; and (iii) the similarity of various undertakings. Significantly, there is a presumption under which the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities except when “his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case.”²⁹

Similar issues are presented under Section 446(d), which permits a taxpayer to utilize different accounting methods for each trade or business conducted by it. Under Treas. Reg. § 1.446-1(d), two trades or businesses must be “separate and distinct” for a taxpayer to be eligible to use different methods of accounting for the businesses. As an example, Treas. Reg. § 1.446-1(d) suggests that a personal service business and a manufacturing business may be “separate and distinct” in certain cases. For these purposes, trades or businesses will not be treated as separate and distinct unless a “complete and separable set of books and records” is maintained for each trade or business. As described in the Tax Section’s report on Section 199A, which was

²⁸Pursuant to Section 183(d), an activity is presumed to be engaged in for profit if the activity produces gross income in excess of deductions for any three of the five consecutive years which end with the taxable year, unless the Commissioner establishes to the contrary.

Treas. Reg. § 1.183-2(b) provides a nonexclusive list of factors to consider in evaluating a taxpayer’s profit objective, including: (1) the manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his or her advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (7) the amount of occasional profits earned, if any; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation were involved. No single factor is determinative of the taxpayer’s intention to make a profit, and more weight may be given to some factors than others.

²⁹Treas. Reg. § 1.183-1(d)(1).

also newly added by the Act, there is well developed case law on Section 446.³⁰

The Section 414(r) “separate line of business” rules might also be looked to in determining what activities might be aggregated in determining what constitutes a trade or business.³¹

3. Recommendations

a. Investments

As discussed above, we recommend that Treasury and the IRS issue guidance treating investing as being its own silo and allowing UBTI from investments to be reported on an aggregate basis. For this purpose, holdings of partnership interests would be treated as an investment activity so long as the organization (and its related parties) do not control the partnership under the standard noted above.

b. Determining Categories of UBTI

New regulations specific to the Siloing Rule should be promulgated, as opposed to simply referencing the regulations utilized in the Code Sections discussed above, because the existing rules are based on very different statutory regimes and include factors that are not relevant to UBIT.

In general, we recommend that guidance for determining unrelated trades or businesses operated and controlled by the organization, be based on the conceptual underpinnings of the passive activity loss rules and hobby loss rules. Specifically, guidance should provide that an exempt organization can aggregate its controlled trades or businesses using any reasonable

³⁰See NYSBA Tax Section Report No. 1392, “Report on Section 199A”, March 23, 2018. Guidance defining a “trade or business” will also be needed to be issued under Section 199A, as added by the Act.

³¹Section 414(r) requires that employers who wish to treat their qualified retirement plans on a separate line of business basis, rather than on a controlled group basis, provide notice to the IRS that the employer treats itself as operating qualified separate lines of business.

method as under the Section 469 regulations.³² Further, the use of broad categories based on a facts and circumstances test should be sanctioned.³³

Treasury and the IRS should define a set of principles to be utilized to determine categories. The passive activity and hobby loss rules are instructive here in their focus on similarities and differences in types of trades or businesses and organizational and economic interdependencies between or among the activities. The definitions utilized should be simple and administrable, as was the goal of Treasury and the IRS in drafting the passive activity rules.³⁴ For example, all of a college's activities to utilize its campus during the summer and other times school is not in session could be grouped into one trade or business, whether it be a swim camp or summer fair.

Taxpayers should be afforded flexibility in determining appropriate categories,³⁵ similar to the passive activity loss rules and hobby loss rules. As in the case of the passive activity rules, we believe that the regulations should clarify that more than one grouping is acceptable (*i.e.*, food sales at a stadium could be grouped with all food sales activities conducted across the exempt organization or all sales activities at the stadium).³⁶ If this method is followed, anti-abuse rules such as those applied to the passive activity loss rules should be provided for UBIT. There should be limits on regrouping, required disclosure, and the Commissioner should have

³²We note that temporary regulations in the passive activity loss context that existed prior to the current regulations applied complex mechanical rules and, as they were criticized as unworkable and a burden on small taxpayers, were allowed to automatically expire after three years pursuant to Section 7805(e) and were replaced with the current approach. *See* Former Treas. Reg. § 1.469-4T, 57 FR 20802.

³³In the passive activity rules, a definition of "activity" was not provided in the statute, but Treasury and the IRS chose to limit gains and losses to an "appropriate economic unit." Treas. Reg. § 1.469-4(c)(1).

³⁴57 FR 20802.

³⁵We note that, regardless of the guidance that is issued, well-advised taxpayers can transfer UBIT producing activities to a taxable subsidiary not subject to the limitations set forth above. However, whereas only part of the income from certain activities is UBIT (*i.e.*, debt financed income), use of a for-profit subsidiary would result in all of the income from the activity being subject to tax. Nevertheless, the fact that offsets of all gains and losses is permitted in this structure is interpreted by some to suggest that the regulations should be flexible and not overly restrictive with respect to the definition of a trade or business.

³⁶*Cf.* Treas. Reg. § 1.469-4(c)(3).

authority to regroup activities to prevent tax avoidance.

c. Other Recommendations

- Expenses that do not relate to specific trades or businesses (*i.e.*, administrative staff overhead, office expense, tax preparation fees) should be allocated among categories on any reasonable basis. Allocations, for example, could be in proportion to the gross income of the businesses or the relative fair market value of the businesses.

- Fringe benefits giving rise to UBTI should be grouped with the activities to which the underlying salary relates. This method accords with the underlying business grouping principle of the statute. Another approach would be to allocate income or loss from such category across all categories. However, such a result would seem contrary to Congress’s intention to have each “trade or business” stand alone (as income or loss from an activity that is not related to that “trade or business” would be considered). It would also be possible to treat fringe benefits treated as an activity that is in its own silo, since this category is conceptually different from other categories because it does not constitute an “unrelated trade or business.” However, this method of grouping makes little sense in the context of the statute, which transforms what is actually an expense into income and by definition can never generate offsetting losses, which is the primary concern of the Silo Rule.

- Payments from controlled entities that are UBTI under Section 512(b)(13) should be grouped in the same silo with the business of the controlled entity (whether or not such business is unrelated to the organization’s exempt purposes). This option seems to accord with the general business grouping principle of the statute more than having such income in a standalone silo with other Section 512(b)(13) UBTI.

- S corporation flow-through income and gains from the sale of S corporation stock that is

deemed to be UBTI regardless of the nature of activity should be part of investment assets if the organization does not control the S corporation as determined according to the same control test applicable to partnerships, as discussed above (the better approach), or alternately, it could be grouped together with the underlying business of the S corporation.³⁷ Such income should not be in its own category because it is not UBTI because of the nature of the trade or business, but because of the form in which the income producing activity is held. Accordingly, it is distinct from the other categories of UBTI.

- Debt-financed income that arises from investment activities should be either part of investment assets (the better approach) or its own category of UBTI. This income is UBTI not due to the nature of the trade or business but, rather, the nature of its financing. The relevant income would be excluded from UBTI but for the financing. However, if the debt-financed income arises from an active trade or business that the organization operates and controls, for example, a research or development business building medical devices, then it should be in its own silo (subject to grouping with other medical device businesses or other research and development businesses).

- Section 512(b)(17) provides that, if an exempt organization is a U.S. shareholder of a CFC, UBTI includes the organization's Subpart F income to the extent attributable to insurance income as defined in Section 953. This Subpart F income is not from a trade or business actively carried on by the exempt organization, but rather is deemed to be UBTI. This Section 512(b)(17) income is distinct from other categories of UBTI. In our view, all Section 512(b)(17) income should be aggregated and put in its own silo.

- Regulations should address the circumstance where an activity resumes after having

³⁷Section 512(e)(1)(B)(i).

ceased to be conducted for a period of time.³⁸ Consistent with the indefinite carryforward now permitted for net operating losses,³⁹ and given that the Siloing Rule has addressed the perceived abuse identified in the Final Report, the Tax Section believes that carryforward of these losses should be permitted without limitation. The regulations should also address the use of NOLs following the entity's ceasing to conduct a trade or business. There is a limited analogy to the freeing up of passive activity losses under Section 469(g) on disposition of an activity in a third-party sale or by death. However, there does not appear to be support in the statutory language for allowing use of the siloed losses across other categories of income in this scenario.

B. Treatment of Certain Fringe Benefits as UBTI

1. Overview of Section 512(a)(7) and Section 274(a)(4)

New Section 274(a)(4) disallows a deduction for the expense of any qualified transportation fringe (as defined in Section 132(f)) (a "QTF")⁴⁰ provided to an employee of the taxpayer.⁴¹ Prior to the enactment of the Act, the disallowance of deductions under Section 274 was generally not relevant for tax-exempt organizations because they are generally exempt from federal income tax.

However, new Section 512(a)(7) that was added to the UBTI provisions of the Code makes the disallowance of certain deductions under Section 274 relevant for tax-exempt organizations. Section 512(a)(7) provides that the amount of a tax-exempt organization's UBTI is increased by an amount:

³⁸*Cf. Portland Golf Club v. Comm'r*, 497 U.S. 154 (1990), and *Atlanta Athletic Club v. Comm'r*, T.C. Memo 1991-83.

³⁹Section 172.

⁴⁰Generally, QTFs are benefits provided by an employer to its employees for their personal transportation and, for the 2018 tax year, include: (i) a ride in a commuter highway vehicle between the employee's home and work place; (ii) a transit pass; and (iii) qualified parking.

⁴¹In addition, Section 274(l)(1) disallows a deduction for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee. However, Section 274(l)(2) excludes from the deduction disallowance amounts paid or incurred for qualified bicycling commuting reimbursements as defined in Section 132(f)(5)(F) after December 31, 2017, and before January 1, 2026. It is noted that such bicycle benefits are taxable income to the employee for such years.

- (i) for which a deduction is not allowable under Section 274; and
- (ii) which is paid or incurred by such organization for any QTF, any parking facility used in connection with qualified parking (as defined under Section 132(f)(5)(C)), or any on-premises athletic facility (as defined in Section 132(j)(4)(B)).

Given that Sections 274(a)(4) and 512(a)(7) became effective on January 1, 2018, and the applicability of Section 274(a)(4) to for-profit organizations, we urge Treasury and the IRS to exercise its regulatory authority to provide interpretive and technical guidance to clarify (i) the interpretation of the language under Section 274(a)(4), which impacts both for-profit organizations and tax-exempt organizations, and (ii) for tax-exempt organizations, the appropriate manner to determine and report their UBTI under Section 512(a)(7).

2. Pre-Tax Employee-Funded QTFs

There has been much debate among commentators and practitioners following the passage of the Act on the meaning of “any amount ... which is *paid or incurred* by such organization for any [QTF or] any parking facility used in connection with qualified parking” (emphasis added) in Section 512(a)(7).⁴² The type of QTF that most clearly illustrates the interpretive conundrum is employee-funded pre-tax transit passes under Section 132(f)(1)(B), although similar issues can arise with respect to other types of QTFs.

By way of background, under Section 132(f)(1)(B), transit pass QTFs may be employer-funded or employee-funded through a pre-tax salary reduction arrangement, or a combination of both. In the employer-funded context, the employer is essentially providing the transit pass (a non-taxable fringe benefit) on top of the employee’s normal base salary, resulting in a greater compensation package than in the employee-funded context, where the employee is merely given the opportunity to enter into a salary reduction arrangement and divert some of his or her base

⁴²Neither the Conference Report nor H.R. Rep. No. 115-409 (2017) (hereinafter, the “Committee Report”) sheds light on the intent behind this language as it uses the same “paid or incurred” language as the statute.

salary to purchase transit passes on a pre-tax basis. In both cases, the value of the transit pass QTF is excluded from the employee's income.

Of the two prongs of the Section 512(a)(7) test described above, there is little disagreement that the first prong (which requires that a deduction be disallowed under Section 274 if the benefit is “provided” by the employer) is met in the case of a transit pass QTF, whether it is employer-funded or employee-funded. Indeed, the IRS made that point clear in its latest Publication 15-B, *Employer's Tax Guide to Fringe Benefits for use in 2018* (dated February 22, 2018)⁴³ where it stated in a “Tip” on page 21 that “no deduction is allowed for [QTFs] (whether provided directly by [the employer], through a bona fide reimbursement arrangement, or through a compensation reduction agreement).” We note that Section 274(a)(4), when describing QTFs for which the deduction is disallowed, uses the language “*provided* to an employee of the taxpayer” (emphasis added), rather than the “paid or incurred” language in Section 512(a)(7).

With respect to the second prong of Section 512(a)(7), the question then becomes whether the transit pass QTF was “paid or incurred” by the organization. There is little disagreement that, in the case of an employer-funded transit pass, the employer has “paid” for the QTF that was provided to the employee and, thus, would meet the second prong of Section 512(a)(7). However, the thinking diverges widely on the treatment of employee-funded transit passes.

Commentators and practitioners who favor exempting employee-funded transit passes from Section 512(a)(7) argue that where the transit pass is employee-funded (and does not result in additional cost to the employer, other than the administrative overhead of maintaining the pre-

⁴³Publication 15-B, *Employer's Tax Guide to Fringe Benefits for use in 2018*, available at <https://www.irs.gov/pub/irs-pdf/p15b.pdf>

tax transit pass program), the amount of the transit pass purchased by the employee's own wages is not "paid or incurred" by the employer. Support for this more literal reading of "paid or incurred" may be found in the fact that, in a similar context, Section 274(a)(4) uses the broader language "provided," which may be read to include providing the opportunity to an employee to make pre-tax salary elections for transit passes. Therefore, proponents of this interpretation argue that, except for the administrative overhead costs incurred by the organization to operate a QTF program which increase UBTI for the organization, the amount of the QTFs themselves (such as transit passes) that are funded by employee pre-tax salary reductions (rather than employer-funded) should not result in an increase in UBTI for a tax-exempt employer.

The arguments on the other side, which would interpret Section 512(a)(7) to cover QTFs even if they are completely employee-funded, as a starting point focus more on the Congressional intent behind Section 512(a)(7), which was expressed in the Committee Report as "aligning the tax treatment between for-profit and tax-exempt employers with respect to non-taxable transportation ... benefits."⁴⁴ Here, it is worth noting that treating QTF expenses as UBTI, regardless of the source of funding, would effectively subject the tax-exempt organization to a double tax cost in cases where its employees work on an unrelated business, because it would lose the deduction for such expense *and* owe tax on the UBTI it generated, thus putting tax-exempt employers in a comparatively worse treatment than for-profit employers, contrary to the intent of the statute. We request that Treasury and the IRS provide relief from the double tax cost to tax-exempt organizations in these situations.

For a for-profit employer, as noted above, the disallowance of a deduction would apply regardless of whether the QTF was employer-funded or employee-funded. For the employee, the

⁴⁴Committee Report at 266.

exclusion from income under Section 132(f) similarly applies whether it is employer-funded or employee-funded. It should then follow that the increase in UBTI under Section 512(a)(7) should apply regardless of whether the QTF was employer-funded or employee-funded. Further, the language “paid or incurred” may also be read to support this position, because even employee pre-tax salary reductions constitute compensation that the employer would have otherwise paid to the employee, but for the election of the employee which instead results in the employer “paying” a portion of that compensation to the transit pass vendor to purchase transit passes. However, this interpretation would have the effect of subjecting to UBTI all tax-exempt organizations in jurisdictions that legally require employers to provide public transport benefits to employees, such as New York City, requiring all such organizations to file Form 990-Ts.

We believe the latter of the two positions is a more reasonable interpretation of Section 512(a)(7) in light of the legislative history and recommend that Treasury and the IRS clarify that even QTFs (such as transit passes) that are completely employee-funded (via a salary reduction arrangement) constitute amounts that are “paid or incurred” by the tax-exempt organization.

3. Parking Facilities In Connection with Qualified Parking

With respect to the application of Section 512(a)(7) to parking facilities (as described in the statute), there are two main areas that could benefit from additional guidance from Treasury and the IRS. The first is whether any interpretive significance should be attributed to the apparent redundancy in the second prong of Section 512(a)(7), where it captures “amounts paid or incurred ... [for any QTF, or] any parking facility used in connection with qualified parking (as defined under Section 132(f)(5)(C)).” This language seems duplicative because “qualified parking” is a subset (*i.e.*, one type) of QTFs and, even absent the later language referring to parking facilities and qualified parking, it would have been captured by the earlier language referring to QTFs.

In addition, it could be argued that, given the evolution of the language in the proposed Section 274(a)(1)(E) from the original House Bill⁴⁵ (which initially had an express reference to a “parking facility used in connection with qualified parking”) to the final language of Section 274(a)(4) in the Act (which struck that reference), the corresponding provision in Section 512(a)(7) referencing such “parking facilities” should have no applicability or effect. This interpretation is similar to the one made under subsection 4 below pertaining to the “on-premises athletic facilities” language. However, while on-premises athletic facilities are clearly **not** disallowed as a deduction under Section 274 under the final language of the Act, the same cannot be said for “parking facilities used in connection with qualified parking.” Even absent the express reference to such “parking facilities” in Section 274(a), it is likely that the cost of maintaining a parking facility used in connection with qualified parking would still be disallowed as a deduction because qualified parking is still a QTF, and deductions for all QTFs are disallowed under Section 274(a)(4) of the Act.

Treasury and the IRS should clarify whether the later language (“parking facilities used in connection with qualified parking”) is meant to be (i) an expansion of the types of parking facilities that are meant to be captured under Section 512(a)(7) beyond QTFs (and, if so, what the parameters are of that expansion), (ii) no broader than what is covered under the earlier QTF language, or (iii) disregarded as a drafting mistake in the Act (*i.e.*, it has no meaning or applicability).

Assuming that Treasury and the IRS do not disregard the “parking facilities” language in Section 512(a)(7), the second area for which guidance from Treasury and the IRS is needed involves the calculation of the UBTI when an organization has a parking facility that is used in

⁴⁵ H.R. 1, 115th Cong. § 3308 (2017) (hereinafter, the “House Bill”).

connection with providing qualified parking to its employees. The questions and issues that commentators and practitioners have debated can be summarized in the following of series questions:

- (i) Does the expense actually incurred by an organization to maintain a parking facility (or a specific allotment of parking spaces) that is exclusively used to provide qualified parking to its employees increase UBTI under Section 512(a)(7)?

Beginning with the easiest question first, it would seem that, at a minimum, Section 512(a)(7) was intended to capture the actual expenses incurred by an organization in maintaining a parking facility used exclusively for qualified parking. In the case where only a portion of the parking facility (*i.e.*, a specific allotment of parking spaces) is exclusively designated for employee use, although there may be questions on how to apportion the maintenance expenses of the parking facility for purposes of the UBTI calculation (and one approach could be to use a reasonable pro-ration method, subject to additional guidance from Treasury and the IRS), it would seem that Section 512(a)(7) was also intended to capture the expenses associated with those employee-only parking spaces.

These interpretations are consistent with the legislative intent expressed in the Committee Report. A for-profit employer (under prior law) would have been able to claim a deduction for such expenses related to employee-only parking facilities or spaces (and under the Act would not be allowed a deduction for such expenses). Therefore, the tax-exempt organization incurring the same expenses should have an increase to its UBTI by such amounts. We do not believe there is much disagreement in the application of Section 512(a)(7) in the scenario involving employee-only qualified parking, but this does help set up and highlight the issues in the next question.

- (ii) Does the expense (or a portion of it) actually incurred by an organization to maintain a parking facility that employees and non-employees share, but which has no parking areas or spaces exclusively designated for employee-only use, increase UBTI

under Section 512(a)(7)?

The analysis is less clear for this second question. Analyzing a real world example may be helpful. Assume a tax-exempt organization (*e.g.*, a university or any organization with a large campus) has a parking lot that it maintains for anyone to use (*e.g.*, customers, students, guests, employees, etc.) and, while employees of the organization have a history and practice of using that parking lot (on average using 10% of the parking spots), there are no parking spots or areas exclusively designated for employee-only use. Assume also that the actual expense to the organization of maintaining the entire parking lot is \$10,000 per year.

One approach to applying Section 512(a)(7) to the example above would be to treat a portion of the parking lot as qualified parking using a reasonable pro-ration method (*e.g.*, based on the 10% average use by employees) and to increase UBTI by a pro-rated amount of the actual expense incurred by the employer (*e.g.*, \$1,000 increase in UBTI in the above example). This would certainly appear to be a reasonable interpretation of Sections 512(a)(7) and Section 132(f)(5)(C) but, without guidance from Treasury and the IRS, tax-exempt organizations have no assurances that they are properly interpreting and complying with the requirements of Section 512(a)(7).

Another approach would be to argue that no amount of the expense for the public parking lot should increase the organization's UBTI under Section 512(a)(7). The reasoning underlying this approach is that the tax-exempt organization is not providing "qualified parking" at all to its employees. This argument would appear to have some merit if, for example, the organization's parking lot was limited in size and available only on a first-come first-served basis, and if there was a real possibility on any given day that non-employees (*e.g.*, guests, students, customers) could occupy all of the parking spots, leaving none for the employees. At a minimum, it is not clear that, given the uncertainty that an employee could even find a parking spot, the parking lot

in this example constitutes qualified parking “provided by” an organization to its employees under Section 132(f)(5)(C).⁴⁶ With respect to Section 512(a)(7), it could be further argued that, in this example, because the tax-exempt employer would have otherwise maintained the parking lot for non-employees, there is actually no additional cost to the employer to allow employees to also park in this parking lot (if and when parking spots are available). For these reasons, arguably there should be no increase to the organization’s UBTI for the parking lot in this example.

We believe that Treasury and the IRS should issue technical and interpretive guidance clarifying how tax-exempt organizations should calculate its increase in UBTI (if any) under Section 512(a)(7) in the example of a general use parking lot (without any designated or exclusive area for employees). We recommend that where the parking facility is open to the public and employees without charge, that it not be treated as a qualified transportation fringe.

- (iii) Does the amount of the qualified parking (*i.e.*, presumably the market value of the parking spot) that is excludable from an employee’s income under Section 132(f) increase UBTI under Section 512(a)(7)?

This third question looks at the calculation of the increase in UBTI from the employee income-exclusion side of qualified parking. Assuming a tax-exempt organization provides qualified parking to its employees, the value of which is excludable from income for the employee under Section 132(f) (similar to transit passes and other QTFs), would the amount that is excludable from an employee’s income also increase the organization’s UBTI under Section 512(a)(7)? That initially appears to be the case for transit pass QTFs because, in addition to the administrative overhead expenses of maintaining a transit pass program (which increase UBTI for the organization), the value of the transit pass that is excludable from an employee’s income

⁴⁶ Although the factual inquiry of whether a given parking lot constitutes qualified parking within the meaning Section 132(f)(5)(C) existed prior to the Act, it has new relevance to tax-exempt organizations as a result of Section 512(a)(7) and the potential UBTI consequences.

(subject to Treasury and the IRS’s guidance with respect to the earlier sections of this Report) also *appears* to increase the organization’s UBTI. At first blush, this may appear to create an inconsistency in the calculation of UBTI for different types of QTFs, and leads to the question of whether UBTI should be increased by the cost (to the organization) or by the value (to the employee) of the QTF.

However, a closer look at the statutory language in Section 274(a)(4) and the legislative intent (which, as described above, seeks to achieve a certain parity between for-profits and non-profits⁴⁷) would suggest that only the actual cost incurred by the employer should increase the organization’s UBTI. The express language of Section 274(a)(4), which disallows a deduction for the “expense” of any QTF, does not state that the “value” of the QTF is disallowed as a deduction by a for-profit organization. Where the fair value of qualified parking exceeds the cost of providing it (*e.g.*, \$500 fair value of a parking space versus a \$100 cost to provide it), we believe that, under prior law, a for-profit organization would have been permitted to deduct only the cost (*i.e.*, \$100) and not the total value excludable from income by the employee receiving the qualified parking (*i.e.*, \$500). Therefore, under the Act, the amount disallowed as a deduction under Section 274(a)(4) and the increase to UBTI under Section 512(a)(7) should be \$100 cost of the qualified parking.⁴⁸

The “cost” approach to UBTI can be applied consistently to transit passes as well. A for-profit organization, in the absence of new Section 274(a)(4), would have been able to deduct as compensation to its employees the cost of transit passes, whether employer-funded or employee-

⁴⁷The legislative intent expressed in the Committee Report was to have a tax-exempt organization incurring QTF expenses increase its UBTI by the amount that, if incurred by a for-profit employer, would have been deductible under prior law but would be disallowed as a deduction by the Act.

⁴⁸ Indeed, Notice 94-3 Q/A 10 describes the value of parking generally as relevant for determining the amount (if any) to be included in an employee’s income.

funded.⁴⁹ For transit passes, the “cost” of the transit pass often is equal to the “value”⁵⁰ that is excludable by the employee and we believe this is what creates the initial impression of an inconsistency (noted above) when comparing transit passes to qualified parking. Using the “cost” approach for both appears to eliminate that inconsistency. On this third question, we recommend that Treasury and the IRS issue guidance that clarifies that the increase to an organization’s UBTI is based on the cost of the QTF, and not the value that is excludable from the income of an employee who receives the QTF.

In any guidance issued on the calculation of UBTI related to parking facilities used for qualified parking, Treasury and the IRS should consider its application to extreme situations, such as where the cost of maintaining a parking facility is effectively zero (or a de minimis amount) to the organization (*e.g.*, unimproved land owned by the organization, with a complete property tax exemption, that is used to provide qualified parking). In particular, Treasury and the IRS should also consider, in the interest of efficient tax administration, whether a de minimis exception to Section 512(a)(7) would be appropriate where the administrative cost and burden of accounting for the increase in UBTI under Section 512(a)(7) outweighs the potential increase in UBTI relating to the provision of QTFs.⁵¹

We recommend that Treasury and the IRS issue guidance on the application of Section 512(a)(7) to parking facilities that addresses the issues, questions, and recommendations discussed above. Specifically, we recommend that Treasury and the IRS, in issuing any future

⁴⁹For example, if an employee has an annual salary of \$100,000 and elects through a pre-tax salary reduction arrangement to purchase \$200 worth of transit passes each month (\$2,400 in total for the year) resulting in the remaining \$97,600 annual salary being paid in cash: (i) under prior law, a for-profit employer would have been able to deduct both the \$97,600 and \$2,400 as a compensation expense and (ii) under new Section 247(a)(4), a for-profit employer would be able to deduct \$97,600 but is disallowed a deduction for the \$2,400 (which is the “cost” of providing the QTF). Accordingly, it would appear that Section 512(a)(7) would increase UBTI by \$2,400.

⁵⁰Except for the overhead administrative expenses of maintaining a transit pass program (and discounts on bulk or monthly transit passes), the cost of the transit pass often equals the value of the transit pass. Unlike the case of qualified parking, there is less likely to be a significant gap between cost and fair market value in the case of transit passes.

⁵¹ Some practitioners also suggest that the IRS should consider whether the increase in UBTI should be equal to the lesser of the cost to the organization of providing the parking and the value to the employee receiving the parking.

guidance, use practical examples illustrating how the increase in UBTI should be calculated for various types of QTFs (and, specifically, for parking facilities that are not exclusively used for qualified parking as described in the examples above).

4. On-Premise Athletic Facilities Has No Applicability

We also recommend that Treasury and the IRS confirm that the reference in Section 512(a)(7) to “on-premises athletic facilities” in the second prong has no applicability or effect. Commentators believe that the statutory language was left in the final version of the Senate bill in error. The predecessor bill to the Act⁵² at one point did include a disallowance of a deduction for on-premises athletic facilities and, in that earlier House Bill, the corresponding reference in Section 512(a)(7) would have been logical. However, because there is no corresponding disallowance of a deduction in Section 274 for on-premises athletic facilities in the law that was ultimately passed by Congress and signed by the President, the reference to “on-premises athletic facilities” should be viewed as a drafting mistake and as having no meaning or applicability.

C. Impact of Certain International Provisions

As noted above, the Section 965 Transition Tax and the GILTI provisions of Section 951(a) raise questions for tax-exempt entities.

1. Overview of Sections 965 and 951A

a. Section 965 Subpart F Inclusions

The Section 965 Transition Tax is imposed on the undistributed offshore earnings of certain foreign corporations. The tax is implemented by increasing the Subpart F income of a specified foreign corporation by the amount of its accumulated post-1986 deferred foreign income. A “specified foreign corporation” is defined as any CFC and any foreign corporation with respect to which one or more domestic corporations is a United States shareholder (defined

⁵²See proposed revisions to Section 274(a)(1)(F) of the House Bill introduced on November 2, 2017.

below). The “accumulated post-1986 deferred foreign income” subject to the mandatory Subpart F inclusion is defined as any earnings and profits of a specified foreign corporation accumulated in tax years beginning after 1986,⁵³ except to the extent attributable to income that is effectively connected with a U.S. trade or business or previously taxed income of a CFC.

Very generally, the Subpart F regime subjects U.S. shareholders of CFCs to current taxation on their pro rata shares of the CFC’s Subpart F income. This income inclusion occurs regardless of whether the income is actually distributed by the CFC to the U.S. shareholder. A CFC is defined as a foreign corporation that is over 50% owned by U.S. shareholders. A “United States shareholder”⁵⁴ is defined as a U.S. person who owns at least 10% of a CFC.⁵⁵ Thus, for purposes of the Section 965 Transition Tax, U.S. shareholders of a specified foreign corporation must include in income their pro rata share of the accumulated offshore earnings as Subpart F income.⁵⁶

b. Section 951A GILTI Inclusions

Under new Section 951A, U.S. shareholders of CFCs are required to include in gross income for each tax year their GILTI, generally defined as the excess of a CFC’s annual net income over a benchmark rate that is based on the CFC’s depreciable tangible personal property. Section 951A(f)(1)(A) specifies that any GILTI required to be included in gross income is treated “in the same manner” as a Subpart F inclusion for purposes of applying various enumerated Code sections. Section 951A(f)(1)(B) also authorizes Treasury and the IRS to

⁵³Such amount is determined as of November 2, 2017 or December 31, 2017, whichever is greater. Section 965(a).

⁵⁴Hereinafter, “U.S. shareholder.”

⁵⁵For tax years beginning after December 31, 2017, the Act amended Section 951 to (a) expand the definition of “U.S. shareholder” to include U.S. persons owning 10% of the vote *or value* of a foreign corporation, and (b) eliminate the requirement that a corporation must be controlled for at least 30 days before Subpart F inclusions apply. However, neither of these revised rules applies to an inclusion year subject to the Transition Tax, which is effective only for tax years beginning *before* January 1, 2018. However, it is unclear whether the 30-day requirement would apply to the second non-CFC type of specified foreign corporation in Section 965(e)(1)(B).

⁵⁶Such Subpart F inclusions under Section 965 are taxed at rates of 15.5% for liquid assets and 8% for other earnings for corporations and slightly higher rates for individuals, who are not eligible for certain deductions that lower the corporate rate.

extend the application of this Subpart F characterization to other income tax provisions not already listed.

2. Net Investment Income Issues

One question that arises is whether the income inclusions under the Section 965 Transition Tax and the GILTI tax should be included in net investment income for purposes of the excise taxes on net investment income under Sections 4940 and 4968.

a. Net Investment Income Generally

Certain exempt organizations are subject to excise taxes on their net investment income under both existing and new Code provisions. Section 4940 imposes a 1% or 2% excise tax on the annual net investment income of private foundations. The Act also added Section 4968, which imposes a separate 1.4% excise tax on the net investment income of certain private colleges and universities and which cross-references to the definition of “net investment income” in Section 4940. In turn, Section 4940(c)(1) defines “net investment income” as the amount by which the sum of gross investment income plus capital gain net income exceeds allowable deductions.⁵⁷ Section 4940(c)(2) defines “gross investment income” as “the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties, but not including any such income to the extent included in computing the tax imposed by section 511. Such term shall also include “income from sources similar to those in the preceding sentence.”⁵⁸ Treas. Reg. § 53.4940-1(d)(1) contains a similar definition of “gross investment income” but elaborates that it also specifically includes “items of investment income described in § 1.512(b)-1(a).”

b. Section 965 Inclusions as Investment Income

⁵⁷Net investment income is determined under the general taxation principles of Subtitle A, except to the extent that these principles are inconsistent with Section 4940. Section 4940(c)(1).

⁵⁸Section 4940(c)(2).

As a preliminary observation, the Section 965 Transition Tax inclusion amount will never be included in the net investment income of private colleges and universities under Section 4968. This is due to the fact that Section 4968 is only applicable to tax years beginning after December 31, 2017, whereas the Section 965 Transition Tax only applies to taxable years that begin before January 1, 2018.⁵⁹

For private foundations to which the Section 965 Transition Tax may apply, the definition of net investment income under Section 4940 does not mention Subpart F income. Further, there is no guidance that specifically addresses whether Subpart F income is included in net investment income and no obvious consensus on its proper treatment.

On one hand, Subpart F income could be included in net investment income as income similar to a dividend. The definition of net investment income in Section 4940(c) could be sufficiently broad to cover Subpart F income even without naming it, since it includes “income from sources similar to” those specifically enumerated types of investment income, such as dividends. In addition, this view reflects the economic reality that the Subpart F regime causes U.S. shareholders to recognize the functional equivalent of a dividend from the foreign corporation. Like a dividend, U.S. shareholders take into account Subpart F income only to the extent of the foreign corporation’s earnings and profits. Although the accumulated deferred foreign income is added to Subpart F through the special mechanism of Section 965 rather than the normal Subpart F regime, this distinction should be irrelevant to its treatment under Section 4940.

If the Section 965 Transition Tax inclusion were treated as net investment income under Section 4940, it raises the question of whether it should be included in income when it arises or

⁵⁹Act § 13701(c), Section 965(a).

only when there is an actual distribution by or sale of a CFC. As analogous guidance, Section 1411 imposes the 3.8% Medicare tax on net investment income only when a CFC makes a distribution or is sold by a U.S. shareholder.⁶⁰ Upon closer analysis, however, this timing feature of Section 1411 is actually rooted in a substantive difference. Subpart F inclusions clearly do *not* fall within any of the categories of income items that comprise net investment income under Section 1411(c).⁶¹ In contrast, if the Section 965 Transition Tax inclusion were to be treated as covered in the statutory definition of net investment income under Section 4940, which, as discussed above, includes “income from sources similar to” dividends, then by its own terms, such amount must be included in income, and thus in net investment income, in the year in which it arises, regardless of whether there is any distribution.

On the other hand, it is possible that Subpart F income may *not* be net investment income because Subpart F inclusions are not called dividends under the Subpart F regime itself, and Treasury and the IRS has signaled its general hostility to treating Subpart F income as dividends in various contexts unless specifically mandated by statute.⁶² Except as discussed below in the context of the UBTI, when Subpart F inclusions are treated as dividends or actual distributions for other purposes (for example, for purposes of the passive foreign investment company regime), a Code section provides for such treatment.⁶³ In addition, depending on the resolution of the timing of inclusion question raised above, it could be argued that Subpart F and Sections 965 inclusions are not “income from sources similar to” dividends included in the definition of

⁶⁰However, under Treas. Reg. § 1.1411-10(g)(1), taxpayers may elect to treat their Subpart F inclusions as dividends that are currently included their net investment income.

⁶¹See Section 1411(c); Treas. Reg. § 1.1411-10; Notice of Proposed Rulemaking, Fed. Reg. Vol. 77, No. 234B, p. 72611 (December 5, 2012).

⁶²See section III.C.3.a below for a discussion of *Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *aff'd* 722 F.3d 306 (5th Cir. 2013), a case that held that Subpart F income inclusions were *not* dividends for purposes of the qualified dividend rate.

⁶³For purposes of determining “excess distributions” under the passive foreign investment company regime, “any amount included in gross income under section 951(a)(1)(B)” must “be treated as a distribution received with respect to the stock.” Section 1298(b)(8). In addition, for purposes of applying the gross income test to a “regulated investment company”, Section 851(b) treats Subpart F inclusions as dividends to the extent the corporation makes a distribution out of earnings and profits during the same year.

net investment income because, among other things, dividends generally are included in income only when actually paid (a cash method concept) and do not accrue based on when earnings and profits are generated.

In light of this uncertainty, we request that Treasury and the IRS issue guidance to confirm the proper treatment of Subpart F income, including the Section 965 Transition Tax inclusion amount, as applicable, for purposes of the net investment income rules of Section 4940. We note that Subpart F income (including Section 965 inclusions) as it arises *and* actual distributions by a CFC cannot *both* be taxable to its tax-exempt U.S. shareholder. Guidance should confirm this.

The election to pay the Section 965 inclusion amount in 8 installments raises a timing question. Section 965(h) provides an election allowing the payment of the Section 965 Transition Tax liability over 8 years. Query whether Treasury and IRS guidance could provide that the Section 4940 tax similarly could be paid over 8 years. In this regard, taxpayers regularly enter into tax payment plans with the IRS without altering the timing of their substantive tax liability or corresponding income recognition. However, the statute clearly provides that the Section 965 income is reportable in the taxable year that begins before January 1, 2018. Absent a statutory change, the better reading is that any Section 4940 tax payable with respect to such Section 965 income inclusion should be paid in the year of the income recognition.

c. Section 951A Inclusions as Investment Income

Unlike the Section 965 Transition Tax, the GILTI tax under Section 951A is relevant to the definition of net investment income both for private foundations subject to Section 4940 and for private colleges and universities subject to Section 4968. Section 951A and Section 4968 have the same effective date of tax years beginning after December 31, 2017.

We believe that GILTI inclusion amounts should be subject to the same treatment as the

Section 965 Transition Tax inclusions discussed above and that Treasury or the IRS should issue guidance to specifically confirm such treatment. GILTI is required to be included in gross income “in the same manner” as a Subpart F inclusions, and Sections 4940 and 4968 both use the same definition of “net investment income,” which includes “income from sources similar” to those specifically enumerated in the statute. It is worth noting that GILTI is not technically Subpart F income, which is defined in Section 952, and Subpart F income is calculated at the level of each individual CFC and is limited by the earnings and profits of such CFC, whereas GILTI is calculated at the U.S. shareholder level by aggregating results from all CFCs and without regard to earnings and profits. However, GILTI can still be viewed as serving an economically similar purpose as Subpart F income and should be treated consistently with it for purposes of Sections 4940 and 4968. As such, we request that any guidance issued with respect to Subpart F income and the net investment income rules also specifically address and apply to GILTI income as well and to the same extent. If GILTI is taken into account in net investment income, Treasury and the IRS should also provide guidance about whether GILTI should be included in the year in which it arises or only when there is an actual distribution or sale.

3. UBTI Issues

Another question relates to whether tax-exempt organizations should include the Section 965 Transition Tax and GILTI tax inclusions in UBTI.

a. UBTI and Subpart F Income Generally

Section 511 imposes a tax on the UBTI of exempt organizations, which is defined in Sections 512-513 as gross income earned by an organization from any trade or business that is regularly carried and that is not substantially related to the exercise or performance of the organization’s purpose or function. Section 514 further includes debt-financed income in UBTI. This general definition of UBTI is subject to certain deductions and modifications. Notably,

Section 512(b) specifically excludes certain types of income from UBTI, including dividends and all deductions directly connected with dividends.

The IRS has ruled in various private letter rulings that Subpart F income should be characterized as a “dividend” and thus excluded from UBTI.⁶⁴ However, the IRS does not cite any statutory or regulatory support for its treatment of Subpart F inclusions as dividends in these rulings, which contain little discussion of their reasoning. For example, in private letter ruling (“PLR”) 8836037, the IRS recognized that Subpart F income is “technically not a dividend,” but treated it as a dividend nonetheless because “the income is functionally equivalent to a dividend.”⁶⁵

However, in PLR 9043039, the IRS looked through a CFC to treat Subpart F inclusions as if they were earned directly by its exempt organization shareholder for purposes of computing the organization’s UBTI. The IRS provided no reasoning for this anomalous approach, which it did not follow in subsequent rulings, and which did not impact the non-UBTI treatment of the income, which was excluded from UBTI in any case under Sections 512(b)(1) and (5).

In the legislative history of Section 512(b)(17), Congress set out its view that the outlying PLR 9043039 was incorrect. Instead, Congress explained that it intended to generally exclude Subpart F income from UBTI. The House Ways and Means Committee Report, the Conference Report, and the Joint Committee on Taxation Report on the Small Business Job Protection Act of 1996, which added Section 512(b)(17), all discuss with approval the IRS’s general treatment of Subpart F inclusions as dividends for UBTI purposes.⁶⁶ Each of these reports explains how accordingly, under prior law, insurance income earned by CFCs that was Subpart F income had

⁶⁴See PLRs 201430017 (May 2, 2014), 201043041 (October 29, 2010), 199952086 (January 3, 2000), 9507007 (November 12, 1993), 9027051 (April 13, 1990), 9024086 (March 22, 1990), 9024026 (March 15, 1990), 8922047 (March 6, 1989), 8836037 (June 14, 1988), 8819034 (February 10, 1988).

⁶⁵PLR 8836037 (June 14, 1988).

⁶⁶H.R. Rep. No. 104-586, at 136 (1996); Conf. Ref. No. 104-737, at 294 (1996); Joint Comm. on Taxation, JCS-12-96, at 214 (1996).

been excluded from UBTI. In order to address perceived unfair competition between exempt organizations and taxable entities engaged in insurance activities, Congress enacted a special look-through rule in new Section 512(b)(17) that treats any insurance income earned by a CFC as UBTI to its exempt organization U.S. shareholders. The implication in doing so was that Congress wanted to maintain the general UBTI exclusion for Subpart F income, except with respect to insurance income, which it specifically treated as UBTI in Section 512(b)(17). If Congress had intended to change the treatment under prior law of Subpart F income as UBTI in general, it would have explicitly done so, just as it had done with respect to insurance income in particular.

This Congressional approval of the general exclusion of Subpart F income from UBTI has in turn been cited by the IRS, which has noted in the “Law” section of post-1996 private letter rulings that Congress has stated that “income inclusions under Subpart F have been characterized as dividends for unrelated business income tax purposes” and that this is the correct result.⁶⁷

Despite the apparent agreement of the IRS and Congress that Subpart F should not be UBTI, this position lacks certainty. The PLRs appear to be fairly conclusory and results-oriented. Critically, they cannot be relied upon by taxpayers. A relatively recent case, *Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *aff’d* 722 F.3d 306 (5th Cir. 2013) also casts doubt on the treatment of Subpart F as dividends for UBTI purposes. *Rodriguez* applied a literal interpretation of the Subpart F rules to deny the preferential qualified dividend rate to Subpart F inclusions, with the Fifth Circuit noting that “when Congress decides to treat certain inclusions as dividends, it explicitly states as much, and Congress has not so designated the inclusions at

⁶⁷See, e.g., PLR 201043041 (October 29, 2010).

issue here.”⁶⁸ This suggests that unless and until Congress amends the rules to explicitly treat Subpart F income as dividends for UBTI purposes, taxpayers (and the IRS and courts) cannot rely on nonbinding PLRs or legislative history to treat them as such. Accordingly, it is important that Treasury or the IRS issue guidance to provide certainty to taxpayers on the non-UBTI treatment of Subpart F.

b. UBTI and Section 965 and 951A Inclusions

The absence of binding precedent on the status of Subpart F income under the UBTI regime raises questions about how tax-exempt organizations should treat Subpart F inclusions arising from the Section 965 Transition Tax, and such questions are even more pronounced in the case of GILTI income. As discussed above, GILTI inclusions are similar but not identical to Subpart F income. Notably, the UBTI rules in Sections 511-513 are not among the specific Code provisions referenced in Section 951A, which provides that GILTI income is to be treated in the same manner as Subpart F. Read literally and as suggested by *Rodriguez*, GILTI inclusions are not dividends for UBTI purposes, and there is no self-executing catch-all language under the UBTI rules that carves out types of income similar to those that are specifically excluded. However, we think this interpretation is at odds with the well-established policy of the IRS and Congressional intent.

GILTI (and Subpart F income) arguably could be excluded from UBTI under Treas. Reg. § 1.512(b)-1(a)(1), which carves out dividends, interest, payments with respect to securities loans, annuities, income from notional principal contracts, and “other substantially similar income from ordinary and routine investments.” However, regulatory exclusion is by its own terms only available “*to the extent determined by the Commissioner*” (emphasis added). The IRS

⁶⁸*Rodriguez*, 722 F.3d at 311.

has provided no such determination with respect to GILTI, and the PLRs and legislative history with respect to Subpart F cannot be relied upon by taxpayers.

Some take the position that GILTI (and Subpart F income) are not UBTI on the basis that simply owning stock of a CFC is never considered a “trade or business” that could give rise to UBTI, except with respect to dealers in securities.⁶⁹ Because CFCs are C corporations, no look-through should apply except for those provided by statute, such as the rule for insurance activities. However, others take the view that absent a specific exclusion, income from CFCs might be treated as UBTI. Specifically, there is a concern that CFCs may be used to accomplish what an exempt organization could not otherwise do itself, and Treas. Reg. § 1.513-1(b) explains that the primary objective of the UBTI rules was to eliminate unfair competition “by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”

In light of the increasing importance of Subpart F and similar types of income under the Act, there is a significant need for formal guidance on their treatment under the UBTI rules. We think such guidance should specifically exclude Subpart F income (including Section 965 inclusions) and GILTI from the definition of UBTI. Even before the Act, practitioners have called for greater clarity and guidance in this area. For example, the government-appointed Advisory Committee on Tax Exempt and Government Entities (“ACT”) recommended in 2014 that the IRS issue a Revenue Ruling that specifically held that Subpart F income was not UBTI.⁷⁰ The need for guidance is even greater now that tax-exempt organizations will be subject to new income inclusions under Sections 965 and 951A.

⁶⁹Treas. Reg. § 1.513-1(b) defines “trade or business” generally as “any activity carried on for the production of income from the sale of goods or performance of services.” Certain authorities have held that taxpayers who merely hold securities and whose only activities are keeping records and collecting income with respect to such securities are passive in nature and do not rise to the level of a trade or business that would give rise to UBTI. See *Higgins v. Commissioner*, 312 U.S. 212 (1941) and Rev. Rul. 69-754.

⁷⁰Advisory Committee on Tax Exempt and Government Entities, 2014 Report of Recommendations, p. 192.

4. Other Issues

Finally, setting aside the question of how Section 965 inclusions are treated for purposes of the net investment income or UBTI rules discussed above, there is also a third possibility raised by recent IRS guidance that it could be taxable in its own right as a new type of income taxable to tax-exempt organizations. In a Questions and Answers article about reporting Section 965 on 2017 tax returns posted on the IRS website on March 13, 2018, exempt organizations are instructed not to report Section 965 inclusions on Form 990-T but instead to report such amounts on a new “IRC 965 Transition Tax Statement.”⁷¹ While this suggests that Section 965 inclusions should not be treated as UBTI, it also raises a possibility that the IRS will subject tax-exempt organizations to the Section 965 tax independent of any existing regimes for imposing tax on tax-exempt organizations.

This makes little sense because Section 965 inclusions are Subpart F income, and as discussed above, Subpart F income is not generally taxed to tax-exempt organizations except as part of net investment income. In addition, Section 965 does not appear to be drafted with tax-exempt organizations in mind. For instance, “net tax liability,” which is used to compute the amounts owed by a U.S. shareholder under the 8 installment payment plan discussed above, is defined in Section 965(h)(6) by reference to the taxpayer’s regular income tax liability.

The possibility that tax-exempt organizations will be taxed on their Section 965 amounts also raises questions about what rate of tax might apply. In this respect, we observe that it would be highly punitive and inequitable to tax Section 965 inclusions to tax-exempt organizations at UBIT rates (21% for charitable corporations or up to 37% for charitable trusts), particularly since taxable entities enjoy much lower rates for their Section 965 inclusions. The 8% or 15.5% rates

⁷¹ <https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns>

for Section 965 inclusions that apply to taxable entities represent a compromise between the 0% rate on undistributed earnings and the 21% tax that would apply to distributed dividends. For a tax-exempt organization, if the earnings were currently distributed as dividends, they would only be subject to the 1% or 2% net investment income tax under Section 4940, and there is no policy reason that tax reform should increase the tax rate that would apply to undistributed earnings beyond the tax rate on an actual dividend. We recommend that Treasury and the IRS clarify the treatment of Section 965 inclusions for tax-exempt organizations, and we believe that they should not be subject to tax under a new regime but instead treated consistently with other types of Subpart F income and taxed only as net investment income but not as UBTI.

D. 21% Excise Tax on Compensation Over \$1 Million and on Excess Parachute Payments

1. Background

New Section 4960(a) imposes a 21% excise tax on:

- (1) *so much of the remuneration paid (other than any excess parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of \$1,000,000, plus*
- (2) *any excess parachute payment paid by such an organization to any covered employee.*

Section 4960 has two distinct elements. The first imposes a 21% excise tax on compensation in excess of \$1 million paid to a covered employee of an applicable tax-exempt organization and seemingly “levels the playing field” between tax-exempt organizations and publicly-held corporations which cannot deduct the compensation of certain employees exceeding \$1 million.⁷² The second imposes a 21% excise tax on excess parachute payments paid to a covered employee and is modeled after the golden parachute provisions of Section 280G.

⁷²Section 162(m). In crafting Section 4960, Congress liberally borrowed elements from limitations imposed on publicly-held corporations and other taxable employers in 1993. See Section 2115 of the Revenue Reconciliation Act of 1993.

However, unlike Section 280G, the tax on excess parachute payments is imposed on payments made in connection with the employee's separation from employment rather than in connection with a change in ownership or effective control of the employer.⁷³

Guidance under Section 4960 is needed in determining, among other things, what an "applicable tax-exempt organization" is, who a "covered employee" is, what compensation or remuneration is included in determining the excise tax, how payments by related persons are treated, and how excess parachute payments are calculated.

We note that while the 21% rate of the penalty excise tax imposed by Section 4960(a) is the same as that imposed under Section 511(a)(1) on the UBTI of most tax-exempt organizations,⁷⁴ our expectation is that the Section 4960 levy is otherwise independent of the rules at Section 511, *et seq.*, and that the Section 4960 tax would be reported on Form 4720 and not Form 990-T. This should be confirmed in guidance.

We believe it is important for Treasury and the IRS to include a statement in the Section 4960 guidance to the effect that the applicability of the Section 4960 excise tax based on a covered employee's compensation does not create any inference or presumption that the compensation paid is unreasonable or excessive, including for purposes of the self-dealing rules applicable to private foundations under Section 4941 or the excess benefit transaction rules under Section 4958 applicable to organizations described in Section 501(c)(3), (4) or (29). Further, the Section 4960 thresholds are not intended to constitute a ceiling for reasonable compensation or other standard for exempt organizations.⁷⁵ However, compensation and separation payments that

⁷³Further, the Section 4960(a)(2) tax is imposed on the tax-exempt employer while, under Section 280G, an excess parachute payment is not deductible and, under Section 4999, a 20% excise tax is imposed on the employee or other person who receives an excess parachute payment.

⁷⁴Organizations treated as corporations are subject to UBIT at the corporate rate of 21%; organizations treated as trusts are subject to UBIT at trust tax rates of up to 37%.

⁷⁵Similarly, satisfaction of the rebuttable presumption of reasonableness under Treas. Reg. § 53.4958-6 does not insulate an applicable tax-exempt organization from the Section 4960 excise tax.

do not trigger the Section 4960 taxes may still constitute excess benefits under Section 4958 or self-dealing under Section 4941.

2. Applicable Tax-Exempt Organization

The tax only applies to an “applicable tax-exempt organization.” Section 4960(c)(1) defines this to mean any organization which (A) is exempt from tax under Section 501(a) (including Section 501(c)(3), (c)(4) and (c)(6) organizations), (B) is a farmer’s cooperative described in Section 521(b)(1), (C) has income excluded from taxation under Section 115(1), or (D) is a political organization described in Section 527(e)(1). Lack of clarity exists on the treatment of governmental and quasi-governmental entities.

- *Section 4960(c)(1)(C) – Quasi-governmental organizations*

Section 4960(c)(1)(C) includes in the definition of applicable tax-exempt organization those entities which have any income excluded from taxation under Section 115(1).

It is important to recognize that Section 115(1) does not describe a type of organization (as do the other definitions of Section 4960(c)(1)), but rather defines income which is specifically excluded from gross income, as do other exclusions in Part III of the Code. Section 115(1) provides that gross income does not include income derived “from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia.”

Accordingly, organizations described in Section 4960(c)(1)(C) – commonly denoted as “quasi-governmental organizations” – may not otherwise be tax-exempt organizations except as provided under Section 115(1) or other, similar exclusions.

The statute appears to expose quasi-governmental organizations to the excise tax should they have even a single dollar of income excluded from taxation by Section 115(1). In other words, the organization may earn other gross income not subject to the Section 115(1) exclusion.

That result should be confirmed in guidance, as should the conclusion that the exclusion under Section 115(1) is not elective.

Given its narrow construction, it appears reasonable to conclude that Section 4960(c)(1)(C) does not apply to organizations such as states and political subdivisions along with their integral parts, which rely upon the doctrine of intragovernmental tax immunity for their tax status.⁷⁶ Indeed, Section 115(2), the income of which is not contemplated by Section 4960(c)(1)(C), describes “income accruing to the government of any possession of the United States, or any political subdivision thereof.” Some clarification of that result is required, especially in the case of public colleges and universities and their tax-exempt affiliates.

Guidance also is required to clarify whether quasi-governmental entities such as public universities and hospitals which voluntarily sought and received recognition of their exempt status under Section 501(c)(3) – so-called “dual qualified” entities – are included in the application of Section 4960 as a result.

3. Covered Employees: Determining 5 Highest Compensated Employees

Guidance is needed to clarify who is a covered employee. Section 4960(c)(2) provides that:

the term “covered employee” means any employee (including any former employee) of an applicable tax-exempt organization if the employee --

- (A) is one of the 5 highest compensated employees of the organization for the taxable year, or*
- (B) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016.*

The statute does not clearly instruct applicable tax-exempt organizations how to identify their five highest compensated employees.

⁷⁶See Rev. Rul. 71-131, 1971-1 C.B. 28; Rev. Rul. 71-132, 1971-1 C.B. 29; Rev. Rul. 82-2, 1982-1 C.B. 18. Compare Section 511(a)(2)(B) (unrelated business taxable income of colleges and university that are state agencies or instrumentalities is taxable).

a. Compensation vs. Remuneration

The term “compensated” is used for determining who is a covered employee (“one of the 5 highest compensated employees of the organization”).⁷⁷ The term “remuneration” is used for calculating the amounts over \$1 million subject to the 21% excise tax and for determining how much of the covered employee’s remuneration is paid by a related person or governmental entity.

Section 4960(c)(2)(A) is silent as to how an applicable tax-exempt organization identifies its “5 highest compensated employees” for the taxable year. At issue is the definition of “compensated” in Section 4960(c)(2)(A) – calculating precisely what amounts received by the employee are included in order to compose the pertinent list.

Guidance from the for-profit sector is not analogous, as the Section 162(m) definition of “covered employee” includes the chief executive officer, chief financial officer, and the three other highest compensated employees, based on the Securities and Exchange Commission disclosure rules. We note that Section 162(m) also calls for a determination of the “highest compensated” officers in determining who is a covered employee, but only disallows a deduction for “remuneration” in excess of \$1 million.⁷⁸ Further, Section 280G, concerning golden parachute payments, defines “parachute payment” to mean certain payments “in the nature of compensation.”⁷⁹

The term “highest compensated” is not defined. A review of the language of Section 4960 is not determinative. The term “compensated” as used in Section 4960(c)(2)(A) bears no

⁷⁷Section 4960(c)(2).

⁷⁸Although the statutory language of Section 162(m) disallows a deduction for “remuneration” in excess of \$1 million, Treas. Reg. §1.162-27(b) uses the word “compensation” and Treas. Reg. §1.162-27(c)(3) defines compensations by reference to amounts that would (but for Section 162(m)) be deductible, as follows: “ Compensation – (i) general – For purposes of the deduction limitation described in paragraph (b) of this section compensation means the aggregate amount allowable as a deduction under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year.” Remuneration is not defined for purposes of Section 162(m); however, Treas. Reg. §1.162-27(c)(3) provides that compensation does not include remuneration covered in certain parts of Section 3121 (concerning the definition of wages).

⁷⁹Section 280G(b)(2)(A).

relationship to the use of the term in Section 4960(c)(5)(C)(iv) as a carve-out to the definition of excess parachute payments to an individual who is not a “highly compensated employee as defined in section 414(q).”⁸⁰ Nor is the use of the term “compensation” in Section 4960(c)(5)(B) (determining excess parachute payments “in the nature of compensation”) illuminating.⁸¹

Remuneration is defined in Section 4960(c)(3) to mean “wages (as defined in section 3401(a))” with three exceptions. Remuneration does not include designated Roth contributions, and remuneration does include amounts included in income under Section 457(f). The final exception is Section 4960(c)(3)(B), which provides that:

The term ‘remuneration’ shall not include the portion of any remuneration paid to a licensed medical professional (including a veterinarian) which is for the performance of medical or veterinary services by such professional.

We are of the view that compensation should not be read narrowly to mean only remuneration as defined in Section 3401(a). The statutory scheme has been drafted using known concepts and formulations. The determination of covered employee is based on the Section 162(m) concept of “highest compensated” officers. The 21% excise tax is imposed on “remuneration” in excess of \$1 million and on any “excess parachute payment” (which in turn is based, like under Section 280G, on certain payments “in the nature of compensation”). In our view, “remuneration” should be defined as in Section 4960(c)(3), and “compensated” and “compensation” should be read consistently with the determination is based on W-2 information. While the Form 990 definition⁸² used for determining, among other things, the organization’s five current highest compensated employees, is similar in nomenclature to the wording of Section 4960(c)(2), as discussed below, this standard is not, by itself, supportable or appropriate.

⁸⁰The definition of what constitutes a “highly compensated” individual under Section 414(q) was \$120,000 in 2017, a relatively low threshold for the purposes of Section 4960.

⁸¹In this context, the term has its genesis in Section 280G.

⁸²Found in the instructions to Form 990, Part VII, Section A.

b. Not the Form 990 List

Part VII, Section A of Form 990 (and in some cases Schedule J) requires exempt organizations to set forth their five highest compensated employees. However, reliance on that listing in determining an organization's covered persons would be inappropriate. According to the Form 990 instructions, the list of the five current highest compensated employees excludes officers, directors, trustees, and key employees of the organization, all of whom would potentially be included under Section 4960.⁸³ Guidance indicating the distinctions between these similarly denominated standards is appropriate.

Form 990 also includes compensation from "related organizations" with a five-year lookback, an approach not necessarily consistent with the definitions of Section 4960.

There are other reasons why information reporting on Form 990 is of limited value in identifying an organization's five highest compensated employees. The reporting scheme set forth in the instructions to Form 990 was not crafted with Section 4960 in mind. Form 990 is an information return; the identification of compensation therein is intended for public consumption, not the imposition of tax. Furthermore, not every applicable tax-exempt organization described in Section 4960(c)(1) files a Form 990. For example, quasi-governmental entities that derive income excluded from tax under Section 115(1) and churches and religious organizations do not file Forms 990.

Guidance from the for-profit sector is of limited use, as the Section 162(m) definition of "covered employee" includes only the chief executive officer, chief financial officer, and the three other highest compensated officers, based on the Securities and Exchange Commission

⁸³The Form 990 instructions (for 2017 at pages 26-27) provide generally for officers and other employees, reportable compensation consists of amounts required to be reported on Form W-2, box 1 or 5 (whichever amount is greater) (plus Form 1099-MISC, box 7 if the officer or employee is also compensated as an independent contractor of the filing organization or a related organization). For nonresident alien employees for whom compensation reporting on Form W-2, Form 1099-MISC, or Form 1042-S is not required, treat as reportable compensation in column (D) or (E) the total value of the compensation paid in the form of cash or property during the calendar year ending with or within the organization's tax year.

disclosure rules. The Section 162(m) list of covered employees is limited to officers; the Section 4960 list could include any employee.

c. Generally Based on W-2 Forms

i. No Adjustments; Foreign Employees

It would appear that the initial source of information for determining an organization's five highest compensated employees would be the applicable tax-exempt organization's Form W-2 filings. That is consistent with Form 990 information reporting generally and, importantly, has obvious relevance to the actual imposition of tax. Guidance is requested on whether, in determining covered employees, W-2 compensation should be adjusted to exclude Roth contributions and other adjustments to remuneration described in Section 4960(c)(3). We recommend that such adjustments to W-2 wages not be used in determining covered employee status.⁸⁴ As discussed above, the definition of compensation for determining covered employee status is different than the definition of remuneration for determining amounts subject to the 21% excise tax.

For foreign employees whose compensation is not reported on a W-2, we recommend that compensation be based on the total value of the compensation paid in the form of cash or property during the calendar year.⁸⁵

ii. Fiscal Year Organizations

Guidance is needed on how Section 4960 applies to fiscal year organizations. The instructions to Form 990 provide that for fiscal year organizations, compensation is determined

⁸⁴We note that amounts set forth on Form W-2 are not necessarily the same as those included under Section 3401(a) as wages. For example, the taxable cost of group-term life insurance in excess of \$50,000 would be reported on Form W-2, but not included as Section 3401(a) wages. But this distinction is consistent with the treatment of "compensation" on the one hand when identifying an organization's five highest compensated employees under Section 4960(c)(2)(A) versus computing the amount of "remuneration" subject to the Section 4960 excise tax.

⁸⁵This is the same standard used in determining compensation for Form 990 purposes. See Form 990 instructions for 2017 at page 27.

based on the calendar year ending within the fiscal year.⁸⁶ Guidance should provide that compensation for Section 4960 should be similarly determined based on amount paid for the calendar year ending within the organization's fiscal year.

d. No Need to Earn over \$1 Million

There is some confusion whether the list of covered employees under Section 4960(c)(2) must be comprised solely of individuals whose compensation exceeds one million dollars. The definition of covered employee at Section 4960(c)(2) appears to be independent of, and a prerequisite for the application of, the monetary standard set forth in Section 4960(a)(1). It appears that under Section 4960(c)(2), to be a covered employee, the employee only has to be among the five highest compensated employees in any given year, without regard to compensation levels.⁸⁷

It is therefore possible (and probably likely for most organizations) that any or all of the five highest compensated employees in a given tax year may earn less than \$1 million that year. Such individuals would not trigger any tax because they are under the \$1 million threshold, but if they receive over \$1 million in compensation in a future year, such amounts would trigger the Section 4960 tax, and any excess parachute payments to such individuals could be subject to tax as well. Conversely, an applicable tax-exempt organization could have numerous employees earning more than \$1 million that year, but only five of them would be considered covered employees.

Any guidance should confirm that there is no compensation threshold to be treated as a covered employee.

⁸⁶Form 990 instructions for 2017 at page 25.

⁸⁷This seems clear based on the Section 4960(a)(2) excise tax applying to any excess parachute payment paid to any covered employee. For this purpose, the statute carves out any covered employee who is not highly compensated as defined in Section 414(q), implying that an employee earning well under \$1 million per year could be a covered employee. Section 4960(c)(5)(C)(iv). To be highly compensated, the employee must earn approximately \$120,000 or more, a relatively low threshold.

e. Situations Where Compensation Differs From Remuneration

i. Performance of Services by Medical Professionals

Guidance is needed on several aspects of Section 4960(c)(3)(B)'s and Section 4960(c)(5)(C)(iii)'s exception for payments for the performance of medical or veterinary services by licensed medical or veterinary professionals. Section 4960(c)(3)(B) provides that remuneration does not include that portion of any remuneration paid to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services by the professional. Section 4960(5)(C)(iii) similarly provides that the term parachute payment does not include that portion of any payment made to a licensed medical professional (including a veterinarian) for the performance of medical or veterinary services by the professional.

We request guidance as to what constitutes medical or veterinary services. For example, are dental services considered medical services? We would offer that it should. What about a nurse?⁸⁸ A physician's assistant? A therapist? Anyone with a state license that has some connection to the medical field? Guidance should be given on other related health professions which logically would appear to be the subject of this remuneration exception.

We also request guidance about whether individuals whose pay is excluded from remuneration, such as medical professionals, could also have such pay excluded for purposes of computing their compensation in making the covered employee determination. There is no basis in the statutory language for excluding earnings from the rendering of medical services from the compensation of medical professionals in determining whether such employees are among the organization's five highest compensated. However, the Conference Report contemplates the

⁸⁸In this regard, the Conference Report (at page 494): "A medical professional for this purpose includes a doctor, nurse, or veterinarian."

opposite view,⁸⁹ and as a policy matter, some think that remuneration and compensation should be the same for purposes of determining the top five highest compensated employees. Under this interpretation, medical professionals could be covered employees only if the non-excluded portion of their remuneration (and not their total compensation) put them among the five highest compensated employees under Section 4960(c)(2)(A). In such case, it would be unlikely that medical professionals would be among the top five highest compensated employees.

For example, assume a doctor who is also a hospital administrator is paid \$1,200,000 per year, \$700,000 of which is allocable to services as a doctor and \$500,000 as an administrator. Assume that with pay of \$1,200,000, he or she is among the hospital's top five compensated employees, but that if only the \$500,000 were taken into account, he or she would not be on this list. Guidance should be given on whether this doctor should be treated as a covered employee. Although we think the better reading of the statutory language is that the doctor would be a covered employee, the policy considerations discussed above point to the opposite conclusion.

If the doctor were a covered employee based on the full \$1,200,000 amount, would an excise tax be payable on compensation of \$200,000 (the excess of total compensation of \$1.2 million over \$1 million) or would no excise tax be due? We think the better answer is that no excise tax would be due because the tax only applies to remuneration paid to a covered person in excess of \$1 million and Section 4960(c)(3)(B) provides that "remuneration" does not include amounts paid to a licensed medical professional for medical services. Accordingly, this doctor's remuneration for purposes of Section 4960(a)(1) only would be \$500,000 and the tax would not apply.

As another example, if a hospital's five highest compensated employees are all medical

⁸⁹The Conference Report at 494 provides: "For purposes of determining a covered employee, remuneration paid to a licensed medical professional which is directly related to the performance of medical or veterinary services by such professional is not taken into account, whereas remuneration paid to such a professional in any other capacity is taken into account."

professionals and the sixth highest compensated employee is the hospital's CEO who earns over \$1 million, would the CEO be a covered employee? If the medical professionals counted the full amount of their compensation rather than only their non-excluded remuneration, the hospital would pay no Section 4960 excise tax with respect to these employees (assuming the CEO was not already a covered employee by reason of being one of the five highest compensated employees in a previous year).

- ***How to apportion if dual roles?***

In the context of a university or hospital where a doctor wears more than one hat and practices medicine as well as engages in other activities on behalf of the employer organization, for example as a dean or administrator at the organization's medical center, how should his or her remuneration be apportioned? We would suggest that remuneration should be allocated by the exempt organization between or among different activities using any reasonable method based on the facts and circumstances, including actual time spent in each role. We further offer that a reasonable allocation of income across these functions as agreed by the parties (whether in an individual employment agreement or, for example, a faculty practice plan) that has real economic substance should control, absent facts of circumstances indicating the allocation lacks economic significance or is artificial and motivated by a desire to avoid the Section 4960 tax. The same convention should then apply to the calculation of excess parachute payments, consistent with the exclusion of Section 4960(c)(5)(C)(iii).

- ii. **Covered Employees Not Limited to U.S. Citizens/Residents – Interaction with Section 3401(a) Wages**

There is no indication that Section 4960(c)(2)'s definition of covered employee is limited to U.S. citizens or residents. Thus, from Section 4960 itself, it appears that a non-U.S. citizen or resident (working outside of the U.S.) who is one of the five highest "compensated" employees

of a tax-exempt organization would be a covered employee. However, as discussed above, some take the view that for policy reasons, compensation and remuneration should be the same for purposes of determining the top five highest compensated employees, such that nonresident aliens would not be covered employees. The legislative history to Section 4960 is silent on this issue. If compensation rather than remuneration is the proper metric, it is worth noting that remuneration (which is “wages” as defined under Section 3401(a)) has specific exclusions for remuneration earned by nonresident aliens.⁹⁰ Thus a covered employee who is a non-resident alien would not have any of that compensation count for purposes of the excise tax on remuneration in excess of \$1 million because the compensation is not remuneration as defined in Section 3401(a). However, this covered employee’s remuneration would be subject to the 21% excise tax if and when the employee became a U.S. resident who earns over \$1 million.⁹¹

iii. Minister Pay

Wages under Section 3401(a) do not include remuneration paid for “services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order.”⁹² The consequences of Section 4960(c)(3) using a Section 3401(a) definition for remuneration for purposes of the \$1 million limit, effectively excludes minister pay from the 21% excise tax on remuneration over \$1 million paid to a covered employee.⁹³ Guidance should confirm this exception, unless remuneration rather than compensation is used for determining covered employee status, as discussed above.

f. Indefinite Status of Covered Employees

⁹⁰Section 3401(a)(6).

⁹¹Query whether the organization would be subject to the excise tax on excess parachute payments paid to this nonresident alien individual assuming payments “in the nature of compensation” exceed three times the employee’s base amount.

⁹²Section 3401(a)(9).

⁹³Presumably, the excise tax on excess parachute payments would apply to ministers.

The language at Section 4960(c)(2)(B) includes as covered employees any “covered employee of the organization (or any predecessor) for any preceding taxable year beginning after December 31, 2016.” The definition can only be read to mean that covered employees earlier identified under Section 4960(c)(2)(A) continue as covered employees for the current tax year *ad infinitum*.

On one hand, it may not be excessively burdensome for tax-exempt organizations to keep track of covered employees indefinitely, particularly since the new rule does not apply retroactively. On the other hand, the concept of “once a covered employee, always a covered employee” creates complications in the administration of the statute. For example, under the statute, the termination of an individual’s status as an employee will not similarly terminate his or her inclusion on the list of covered employees. In a similar setting, Section 4958(f)(1)(A) limits the definition of the term “disqualified person” to “any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization....” As a matter of administrative convenience, Treasury and the IRS could consider providing a similar rule under Section 4960 that once an individual has terminated his or her status as an employee and has had no compensated relationship with the former employer (or a related party) for five years, the tax-exempt organization is no longer required to keep track of the individual as a covered employee.

g. Impact of Related Person Payments on Covered Employee Status

i. Generally

Importantly, Section 4960(c)(1) refers to a single organization, without any reference to concepts of aggregation of controlled group members (as, for example, under Sections 414(b) and (c) or 1563) or any other entities for that matter. The relevance of “related organizations” in

Section 4960(c)(4), for example, is specifically limited to the computation of “remuneration” subject to the statute.

Consistency of approach with respect to this unitary perspective should be confirmed in guidance, as it has important implications for the interpretation of the statute. For example, the definition of a “covered employee” in Section 4960(c)(2) is based on the relationship of employee and employer between an individual and a single applicable tax-exempt organization. The plain language of the statute supports the conclusion that an applicable tax-exempt organization has the responsibility to identify and track its own covered employees, and not those of other entities.⁹⁴ This is despite the fact that information reporting on Form 990, required of some applicable tax-exempt organizations but not others, requires amalgamation with respect to some forms of compensation among related entities.

However, it is unclear whether remuneration paid from related organizations, described in Section 4960(c)(4)(B), is to be included in the covered employee determination. We could not reach a consensus on this issue. Some think only compensation paid by the applicable tax-exempt organization should count in determining the organization’s covered employees. Others think guidance should provide that compensation paid to an organization’s employee by a related person should be included in determining the organization’s covered employees. Such a position is arguably supported by the statutory language requiring remuneration of a covered employee⁹⁵ to include remuneration paid by a related person or government. This position is based on the view that all remuneration is compensation while not all compensation is remuneration as defined in Section 3401(a). Also, the Form 990 determination of five highest compensated

⁹⁴The addition of related organization remuneration into an applicable tax-exempt organization’s computation of compensation, for example, is contrary to the selective use of the terms “remuneration” and “compensation” in the statute and would unduly complicate the inquiry from a single entity to its related organization as to whether the latter has paid remuneration to any of its five highest compensated employees.

⁹⁵We do note the circularity in this formulation in a situation where the individual only becomes a covered employee by reason of payments by a related person.

employees includes compensation paid by related organizations. We request guidance on this issue.

ii. Predecessor Entity

It is also unclear what constitutes a “predecessor entity” for purposes of Section 4960(c)(2)(B). No relevant legal standard appears on the face of the statute.⁹⁶

iii. Covered Employees at Each Related Tax Exempt Entity

Section 4960(c)(1) defines what an applicable tax-exempt organization is without reference to any concepts of aggregation of controlled group members (under Sections 414(b)/(c) or 1563). The implication is that each tax-exempt entity, even if part of a controlled group with other tax-exempt entities, must identify and track its own group of covered employees. Thus, a complicated organization which consists legally, for example, of five different exempt organizations would have up to 25 covered employees in any given year and could be subject to the Section 4960 tax on, for example, each of those 25 individuals, while if the same organization were structured as one exempt organization with four or five divisions or disregarded entities, it would be subject to tax only on up to five individuals. Guidance is requested on whether, in the case of a controlled group of exempt organizations, each organization is required to identify and track its own group of covered employees. As an alternative, the determination of covered employees could be based on controlled group rules.

h. Related Organizations

Section 4960(c)(4)(B) requires that remuneration from certain related organizations be aggregated, solely for purposes of computing the amount of total remuneration under Section

⁹⁶It is noted that the determination of who is a “disqualified individual” subject to Section 280G is based in part on compensation earned by the individual for services performed for the corporation with respect to which the change in ownership or control occurs, for a predecessor entity or a related entity. Treas. Reg. § 1.280G-1 Q/A-21(b) provides that for this purpose: “a predecessor entity is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor or entity of the changed corporation.”

4960(c)(3).⁹⁷ Section 4960(c)(4)(C) then provides that those related organizations are liable for their *pro rata* share of the excise tax.

i. Ambiguity in Statutory Language

The express language of Section 4960(a)(1), however, limits the imposition of the excise tax to remuneration paid “by an applicable tax-exempt organization” without reference to any “related organization.” Some reconciliation of the two subsections and confirmation that Section 4960(c)(4)(A) expands the definition of “remuneration” to include remuneration to the employee for employment by a related party would be helpful, perhaps by including a specific reference to related organizations in Section 4960(a)(1) and (2). Query whether the definition should be expanded so as to include for-profit subsidiaries or affiliates and governmental entities.

ii. Meaning of the Term “Control”

Guidance is needed with respect to the meaning of the use of the term “control” and “controlled” under Section 4960(c)(4)(B)(i) and (ii), as it is otherwise undefined. Query whether reference to the controlled group rules under Sections 414(b), (c), (m), and (o) and Treas. Reg. § 1.414(c)-5 is appropriate in this context.

iii. Securing Remuneration Information from Related Organizations

It is unclear from the statute what the contemplated process is for an applicable tax-exempt organization to secure information on remuneration paid by a related organization. This will likely require related organizations to collaborate with one another in a manner unlike how they presently do.⁹⁸ It appears that a related organization could be liable under Section 4960 for remuneration paid to an individual who is not a covered employee of that entity, but of the

⁹⁷This is similar to the compensation reporting on Form 990.

⁹⁸The Form 990 instructions (at page 29) provide that the organization isn't required to report compensation from a related organization to a person listed on Form 990, Part VII, Section A, if the organization is unable to secure the information on compensation paid by the related organization after making a reasonable effort to obtain it, and if it is unable to make a reasonable estimate of such compensation.

applicable tax-exempt organization itself.

iv. Pro Rata Allocation of Tax Due

There are other complications which arise from the inclusion of related organizations as payors of a *pro rata* portion of the penalty excise tax, and should be addressed. For example, assume that a for-profit company appoints, as sole corporate member, the governing board of its company foundation, an applicable tax-exempt organization. A company community relations executive is compensated \$800,000 in that capacity, and is also compensated \$300,000 by the company foundation for personal services rendered to the charity.

The total remuneration under Section 4960(c)(4)(A), including the company as a related organization to the foundation under Section 4960(c)(4)(B)(i), is over the Section 4960(a)(1) threshold, and so (assuming the executive is a covered employee) the mechanical application of the allocation rules at Section 4960(c)(4)(C) results in the imposition of the penalty excise tax, 27% on the foundation and, if applicable, 63% on the company. However, as discussed below in subsection vi, a for-profit affiliate should not be liable for such excise tax. Including the compensation from the for-profit seems improper because the responsibilities of the executive are very different for each entity, and they must be sufficiently distinguishable so that the self-dealing rules of Section 4941 are not implicated. The responsibilities to the company are distinct from those to the foundation, but the strict language of the statute collapses the two.

v. Governmental Entities as Related Organizations

Additionally, the “related organization” definitions under Section 4960(c)(4)(B) include “governmental entit[ies],” without further definition of precisely what those entities are from a tax perspective. If the organization relies upon the doctrine of intragovernmental tax immunity for its tax status, then the apportionment of excise tax liability under Section 4960(c)(4)(C) would seem inappropriate.

vi. Tax Liability for Controlled For-Profit Subsidiaries and Affiliates

For a variety of reasons, tax-exempt organizations may create or acquire a controlling interest in a for-profit, taxable entity. Such an entity would constitute a “related organization” under Section 4960(c)(4)(B).⁹⁹ Similarly, a for-profit company may create a private foundation which it controls. Assume the company has an employee with compensation well in excess of \$1 million per year who serves as the president of the foundation without pay. Would the company be subject to a 21% excise tax on its employee’s total remuneration? We think the better answer from a policy perspective is “no.” Or, in this situation, where the applicable tax-exempt organization pays no compensation, is the corporation’s employee not a covered person and, accordingly, no excise tax would be due?

For the reasons discussed below, we think the Section 4960 excise tax should not be imposed on taxable employers. Section 4960(a) provides that a 21% excise tax is imposed on remuneration paid by an applicable tax exempt organization. Section 4960(c)(4)(A) provides that remuneration includes remuneration paid by any related person or governmental entity. Section 4960(c)(4)(C) provides that where remuneration from more than one employer is taken into account, each such employer shall be liable for its pro rata share of the tax. Where the related party is a for-profit entity or governmental entity (that is, not an applicable tax-exempt organization), Sections 4940(c)(4)(C) and 4940(a)(1) are seemingly in conflict. We think guidance should be issued providing that even though the remuneration paid by a related for-profit or governmental entity generally is taken into account in determining whether the covered employee of the applicable tax-exempt organization has remuneration in excess of \$1 million for purposes of Section 4940(a)(1), the related for-profit or governmental entity is not liable for its

⁹⁹In the unusual case where the subsidiary would be subject to Section 162(m), any remuneration paid by it would be excluded from the definition of remuneration to the extent that a deduction is already denied under Section 162(m). Section 4960(c)(6).

share of the tax.¹⁰⁰ In this regard, under Section 4940(c)(6), remuneration paid by a related party is not taken into account for purposes of Section 4960 if it is not deductible by reason of Section 162(m).

For example, assume a covered employee is paid \$500,000 by tax-exempt organization A and \$1,500,000 by related tax-exempt organization B. Total remuneration is \$2,000,000. The excise tax would be payable on the \$1,000,000 remuneration in excess of \$1,000,000; 25% by tax exempt organization A ($\$250,000 \times 21\% = \$52,500$) and 75% by tax exempt organization B ($\$750,000 \times 21\% = \$157,500$).

Same facts, except organization B is a for-profit corporation. Here, tax-exempt organization A pays the same \$52,500 excise tax, but the for-profit corporation B should not be subject to the excise tax because it is not an applicable tax-exempt organization.

Same facts, except that for-profit corporation B may not deduct the \$1,500,000 remuneration under Section 162(m). Here, the \$1,500,000 paid by corporation B is not treated as remuneration. Accordingly, total remuneration is \$500,000 and no excise tax is payable.

4. Excess Parachute Payments

Section 4960(c)(5)(B)(i) defines a “parachute payment” as one that is “in the nature of compensation” and contingent on a covered employee’s separation from employment with the employer. Section 4960(c)(5)(B)(ii) defines an “excess parachute payment” as a parachute payment where the amount equals or exceeds three times the average of the most recent five year’s compensation (the so-called “base amount,” calculated under rules similar to those under Section 280G(b)(3)). As with the definition of covered employee, the determination of whether there has been an excess parachute payment is based on compensation rather than remuneration.

¹⁰⁰ While we believe this is the right result, as a policy matter, we note that payments from such taxable or governmental entities could occupy top five compensated employee slots, even though minimal excise tax would be due and the tax-exempt organization might directly pay other employees more than \$1 million in compensation.

a. What does “payment in the nature of compensation” mean?

Is it intended to be similar to the very broad Section 280G standard (which is not limited to simply taxable wages, but includes other payments as well)? We note that Section 280G uses the same phrase “payment in the nature of compensation.”

b. What does “contingent on a separation from employment” mean?

We request that Treasury and the IRS clarify the meaning of “separation from employment.” Is separation from employment limited to an involuntary separation from employment (*i.e.*, an employer-initiated termination without cause, an employee’s resignation for good reason, or constructive termination, which often arises from an adverse employer action)? Does a separation from employment include a termination of employment as a result of the employee’s death or disability (which does not result from any employer-initiated action)? If Treasury and the IRS were to adopt an expansive definition of separation from employment (to mean any separation or termination of employment for any reason), we believe that appropriate exclusions from the concept of “parachute payments” should be provided by Treasury and the IRS. For example, if there is a payment that an employee receives upon retirement (at any time after age 65) does that count as being “contingent” on a separation from service? Such a payment would generally be treated as vested and taxable under Section 457(f) once the employee reached age 65 despite it not being paid out until the date of the employee’s resignation/retirement. Section 4960(a) would consider vested amounts under Section 457(f) as “remuneration” that is paid for purposes of the \$1 million remuneration test under Section 4960(a)(1), but the statute is silent on whether those already taxed, vested amounts are again counted as parachute payments under Section 4960(a)(2) when paid. The arguments against treating this as a parachute payment are that (i) those payments (while technically structured to

be paid on a separation from employment) actually represent compensation for past personal services (*i.e.*, not a separation pay or parachute package) and (ii) to count it as a parachute payment would result in the same amount being counted twice – once upon vesting for purposes of Section 4960(a)(1) and again upon the payout following retirement for purposes of Section 4960(a)(2).¹⁰¹ The above examples would appear to favor excluding from “parachute payments” amounts that were already vested and taxable and/or that otherwise represented compensation for past personal services.

c. Reasonable Compensation for Personal Services Exception?

Similarly, is it intended that similar Section 280G exceptions¹⁰² (such as reasonable compensation for performance of future personal services (*e.g.*, in consulting capacity post termination) or for refraining from performing services (*i.e.*, payment for non-compete)) apply under Section 4960 and not count as parachute payments? These points are clarified in the Section 280G regulations, and guidance should be issued in regulations for Section 4960.

5. Regulatory Guidance on Avoidance

Section 4960(d) specifically directs the Secretary to prescribe regulations necessary to prevent avoidance of the tax under Section 4960, including “regulations to prevent avoidance of such tax through the performance of services other than as an employee or by providing compensation through a pass-through or other entity to avoid such tax.”

It would be appropriate for guidance to provide for a “look through” rule for pass through entities (including S corporations, partnerships and limited liability companies), such that there would be a rebuttable presumption that compensation paid by an applicable tax-exempt organization (or a related person) to a pass through entity owned in whole or in part by an

¹⁰¹ It is noted that the Section 280G regulations provide for a special treatment (*i.e.*, a reduction in the parachute payment value) of already vested amounts (Treas. Reg. §1.280G-1, Q/A 24(b)) and for reasonable compensation for personal services (Treas. Reg. §1.280G-1, Q/A 40-44).

¹⁰² See Treas. Reg. §1.280G-1 Q/A 40 - 44.

employee (or person who would be an employee if paid directly by the organization), would be treated as compensation/remuneration to the individual to the extent of his or her ownership in the entity. Further, regulations could provide that payments to an entity for the services of an individual would be treated as paid to such individual to the extent attributable to such individual's services. For example, payments to a C corporation or other entity, whether or not owned by the individual who is performing services through such entity to the tax-exempt organization, would be attributable to such individual.

Consideration could be given to respecting separate entities that are created for non-tax reasons. For example, a university basketball coach will receive compensation from a tax-exempt organization subject to the statute for services rendered as coach, but may also receive compensation arising from various sports camps, instructional videos and streaming, licensing of his or her likeness, media appearances, and so on. For liability, accounting, and other legitimate reasons the coach may employ, for example, a subchapter S corporation or limited liability company. Those legitimate actions could be distinguished from whatever tax avoidance schemes Congress intended that Treasury address.¹⁰³

Since Section 4960 has the concept of "once a covered employee, always a covered employee," what if a covered employee of a tax exempt retired and started a different business and ended up providing consulting/contracting services to the tax exempt? If the change to a consulting arrangement is a subterfuge to essentially provide the same services as those performed while an employee, then regulations should pick it up as subject to the compensation limit. But if the new services to the organization are not the same or substantially similar to the services provided as an employee, compensation for such services should not be subject to the

¹⁰³It is noted the payments addressed in this paragraph would only be relevant to the Section 4960 tax if paid by the applicable tax-exempt organization or a related organization.

excise tax. For example, in the same year as retirement from being the CFO, the former employee goes into a different business and provides consulting services as an individual vendor selling office furniture to the tax exempt. It seems that in this latter case the money earned by the former CFO who now has an office furniture business should not be picked up under the \$1 million compensation limit.

6. Effective Date of Section 4960

Section 4960 is effective for tax years beginning after December 31, 2017,¹⁰⁴ raising issues in need of guidance.

We assume that since the excise tax is imposed on the employer organization, the statute is referring to the employer's tax year.

Guidance is needed to clarify how this rule applies to remuneration paid during 2018. For example, assume an employer has a June 30 tax year, so that the first tax year that begins after December 31, 2017 is the 2018-2019 tax year beginning July 1, 2018. It would be helpful if Treasury and the IRS could confirm that any remuneration paid on or prior to June 30, 2018 would not be subject to the Section 4960 excise tax.

E. 1.4% Excise Tax on the Investment Income of Certain Colleges and Universities

1. Overview of the Tax

New Section 4968¹⁰⁵ imposes an annual excise tax of 1.4% on the net investment income of an "applicable educational institution," as defined in Section 4968(b). This excise tax is similar to the 1% or 2% excise tax under Section 4940 applicable to private foundations. The

¹⁰⁴Act Section 13602(a).

¹⁰⁵It is noted that legislation has been proposed to repeal this tax. According to a Press Release dated March 8, 2018 (as reported in the *EO Tax Journal* for March 12, 2018), "Congressman John K. Delaney (MD-6) and Congressman Bradley Byrne (AL-1) have introduced bipartisan legislation to repeal the excise tax on endowments that was included in the tax reform bill signed into law last year. The tax bill passed last year creates a 1.4% excise tax on net endowment income for institutions with large endowments. Because the legislation did not include threshold adjustments for inflation, it is likely that more and more institutions will be subject to the tax in the future. The Delaney-Byrne Don't Tax Higher Education Act eliminates the tax on endowments..."

Act defines “applicable educational institution” by reference to Section 25A(f)(2) to include all accredited public, nonprofit and proprietary (for-profit) postsecondary institutions¹⁰⁶ that have (a) at least 500 tuition-paying¹⁰⁷ students during the preceding taxable year, of which (b) more than 50 percent of the tuition-paying students are located in the United States.¹⁰⁸ The school must be a private school and not a state or community college or university.¹⁰⁹ Finally, the institution must have at least \$500,000 in assets per student, “other than those assets which are used directly in carrying out the institution’s exempt purpose.”¹¹⁰ In general, the assets and net investment income of related organizations are attributed to the educational institution.

Section 4968(b) includes several provisions in need of guidance.¹¹¹ Specifically, guidance is needed to determine what assets count and how value is measured in determining the number of students and whether the institution has at least \$500,000 in assets per student. Guidance also is needed concerning when and how much of the assets and income of a related organization or person are attributable to the institution for purposes of this provision. Finally, guidance is needed concerning how the new Section 4968 tax is to be calculated.

2. Determining the Number of Students

To be subject to the Section 4968 excise tax, the institution must have at least 500 tuition-

¹⁰⁶Treas. Reg. § 1.25A-2(b).

¹⁰⁷The Senate version of the Act included “tuition-paying” students, but the Conference Committee dropped these words. However, these words were restored as part of the Bipartisan Budget Act of 2018, signed into law February 9, 2018. It is understood this is intended to exempt from the tax Berea College (a college in Kentucky that does not charge tuition but has a large endowment).

¹⁰⁸For this purpose, the number of students of an institution (and the number of students at a particular location) is based on the daily average number of full-time students attending the institution (with part-time students taken into account on a full-time equivalent basis). Section 4968(2).

¹⁰⁹Section 4968(b)(1)(C) provides that an applicable educational institution is not described in the first sentence of Section 511(a)(2)(B), relating to state colleges and universities.

¹¹⁰Section 4968(b)(1)(D).

¹¹¹The Conference Report at 555 provides: “It is intended that the Secretary promulgate regulations to carry out the intent of the provision, including regulations that describe: (1) assets that are used directly in carrying out the educational institution’s exempt purpose; (2) the computation of net investment income; and (3) assets that are intended or available for the use or benefit of the educational institution.”

paying students and must have assets of at least \$500,000 per student. Thus, a threshold for applicability of the Section 4968 tax to an educational institution is a determination of the number of students attending the institution. Neither the statute nor the legislature history define “student.” Section 4968(b)(2) provides that for purposes of determining whether an institution is an applicable educational institution:

the number of students of an institution (including for purposes of determining the number of students at a particular location) shall be based on the daily average number of full-time students attending such institution (with part-time students taken into account on a full-time student equivalent basis).

One issue is the definition of “tuition-paying” students for purposes of determining whether the institution has at least 500 tuition-paying students. Based on the limited legislative history, this provision clearly was intended to carve out from the excise tax schools with large endowments that do not charge tuition to any of their students.¹¹² What about students who receive full scholarships at an institution that generally charges tuition? Based on the statutory language, such scholarship students are not “tuition-paying” and should not be counted for this purpose. What about if a portion of the student aid is a loan or there is a tuition waiver in exchange for work? What about a partial scholarship; is the recipient the equivalent of a part-time student? We request guidance on this.

Another issue is whether both undergraduates as well as graduate students should be counted. Nothing in the statutory language or the legislative history suggests that graduate students should not be counted as students. Guidance is requested confirming that both undergraduate and graduate students count as students.

A further issue is whether students must be in a degree program to count as students. The

¹¹²See footnote 107.

statute speaks of full-time students and part-time students. The statute does not expressly require students to be in a degree program to be counted. Many schools have continuing education programs that permit adult members of the community to attend selective courses which may or may not provide credits towards a degree. That said, it could be inferred that a full-time student is in a degree program. Guidance is requested addressing this issue.

3. Assets Counted for the \$500,000 per Student Determination

a. Which Assets Count

One of the requirements for being an applicable educational institution is that the aggregate fair market value of the school's assets at the end of the preceding taxable year is at least \$500,000 per student of the school, "other than those assets which are used directly in carrying out the institution's exempt purpose."¹¹³ This requires a determination of whether assets are held for educational purposes or for investment purposes. The Conference Report indicates (at footnote 1252) that "[a]ssets used directly in carrying out the institution's exempt purpose include, for example, classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities, among other assets." The statutory language does not limit the types of assets excluded for this purpose to buildings and other tangible property. We recommend that guidance be issued that confirms that various assets, in addition to physical facilities, be treated as used directly in carrying out the institution's exempt purposes.

It is possible that certain endowment funds held and used directly in carrying out the school's educational purposes seemingly could qualify as assets used directly in carrying out the school's exempt purposes. Such assets would include funds set aside for use by the institution for exempt purposes within a relatively short period of time. Some believe that consideration

¹¹³Section 4968(b)(1)(D).

should be given to treating restricted endowment funds held for a specific scholarship or assets set aside to build a new library or classroom as held for the institution's exempt purposes. Along the same lines, they believe that consideration should be given to including dedicated funds, such as a named scholarship fund or funds dedicated to funding a professorship, among excluded assets.

In this regard, one principle could be whether a third party, such as a donor or lender, imposes restrictions on the use of funds. Example 1: A donor sets up a scholarship fund and in the grant restricts its use to providing scholarships for first generation students attending the school. This fund should not be considered investment assets for the test and the scholarships granted should be considered related expenses. Example 2: The school has a capital campaign to build a new science laboratory. The funds raised will be spent within three years. In addition, the school transfers \$100 million from its endowment to the fund. It would seem that the funds raised should not be considered investment assets, but the amount transferred from the endowment (since the restriction is self-imposed) should still be considered investment assets until actually spent. Example 3. The school borrows money to build a new football stadium. While the funds are held temporarily, but earmarked for that purpose, and there is an offsetting loan, there is no addition to assets.

As discussed below, the exclusion of assets from the determination of whether the institution has investment assets of \$500,000 per student would not mean that net investment income from such assets is not subject to the Section 4968 tax, assuming the institution has at least \$500,000 in investment assets per student.

However, others disagreed with this approach of excluding restricted funds used directly in carrying out a school's exempt purposes. As a preliminary note, they draw a distinction

between actual assets used in exempt purposes and cash that is used to fund such assets. As a policy matter, the exclusion might incentivize donors to place restrictions on their gifts and incentivize institutions to request donors to place such restrictions on their gifts. Furthermore, excluding restricted assets might create difficult line drawing problems between what is sufficiently restricted and what is not.

b. Assets and Investment Income of Related Organizations

Section 4968(d) treats the assets and net investment income of any related organization as the assets and net investment income of the applicable educational institution.¹¹⁴ A related organization is any organization that controls, is controlled by, or is under common control with the private college or university, or that is a supported organization described in Section 509(f)(3) or a supporting organization described in Section 509(a)(3) with respect to the applicable educational institution.¹¹⁵

Guidance is needed to determine what constitutes control for this purpose. One possible definition of control is the ability to unilaterally replace a majority (or greater portion) of the board or governing body of an organization. Another possible definition is the Section 512(b)(13)(D) definition of control used for purposes of determining whether amounts received from a controlled entity are subject to UBIT. Consideration should be given to coordinating the interpretation of related organizations, particularly what constitutes control, for purposes of Section 4968 and Section 4960 (concerning the 21% excise tax on compensation in excess of \$1 million paid to covered employees by applicable tax-exempt organizations (which include educational institutions), including by any related person). As discussed in Section III.D.3.h.ii of

¹¹⁴Section 4968(d)(1) provides that “[f]or purposes of subsections 4968(b)(1)(C) and (c) assets and net investment income of any related organization ... shall be treated as assets and net investment income, respectively, of the educational institution” except as provided. The reference to (b)(1)(C) is a mistake. Section 4968(b)(1)(C) provides that state colleges and universities are not subject to the excise tax. The reference should be to Section 4968(b)(1)(D), which concerns the \$500,000 per student requirement.

¹¹⁵Section 4968(d)(2).

this Report, for purposes of Section 4960, we suggest that Treasury and IRS refer to the Treas. Reg. § 1.414(c)-5 definition of “control” meaning a person or entity with the power to appoint 80% of the governing body.

Guidance is needed in determining whether assets of a related organization should be attributed to an institution and what standard should be used. The Conference Report provides that a related organization’s assets “that are earmarked or restricted for (or fairly attributable to) the educational institution would be treated as assets of the educational institution, whereas assets of a related organization that are held for unrelated purposes . . . would be disregarded.”¹¹⁶ A related organization’s assets and net investment income should not be treated as the assets and income of the educational institution if such assets and income are not intended or available for the educational institution’s use or benefit, unless the related organization is controlled by, or is a supporting organization of, the educational institution.¹¹⁷

The statute literally calls for the assets of the related organization to be treated as assets of the educational organization. Two points for guidance. First, in general, assets (and income) of a related organization only should be treated as assets (and income) of the educational institution to the extent of relatedness. For example, in the case of an 80% owned and controlled entity, only 80% of the entity’s assets (and income) should be treated as assets and income of the educational institution. However, in this example, if 100% of the funds of the related organization are dedicated for use by the organization in question, then 100% of the funds should be counted rather than just 80%. Second, consideration should be given to allowing the educational institution to take into account its unique facts and circumstances and to use any reasonable method to value its interests in controlled entities in a way that avoids double

¹¹⁶Conference Report at 555.

¹¹⁷Section 4968(d)(1)(B).

counting. For instance, an educational institution may use the share of the assets of the controlled entity or the value of the educational institution's interest in the controlled entity as the value of the assets owned by the educational organization.

It seems in line with the principles underlying Section 4968 to have the educational institution treated as owning its share of net investment income earned by an entity treated as a partnership.¹¹⁸ Guidance should confirm that the net investment income attributed to the educational institution should be based on the K-1 provided to the institution.

The statute does not preclude the assets of a for-profit company from being attributed to the educational institution. In the case of a for-profit subsidiary of a college or university, inclusion is seemingly mandated even where the assets of the subsidiary are not investment assets in any traditional sense. In such a case, guidance should confirm that value of the assets of the subsidiary considered investment assets is based either on the fair market value of the institution's indirect ownership of the entity's net assets or the fair market value of the institution's interest in the entity itself. We recommend that, in any case, only the net fair market value of the assets of an applicable educational institution or a related party be taken into account and that any reasonable method may be used for determining the net fair market value of such assets. In the case of a for-profit corporate subsidiary, guidance should provide that net investment income is not taken into account by the controlling educational organization until it receives a dividend or the stock is sold.

It is noted that the Section 4968 tax is payable by the educational organization on the net investment income of a related organization. The related organization that earns the net investment income is not subject to the tax.

¹¹⁸See Section 4940 treatment of partnership income.

In determining whether assets and net investment income of a related organization are not available for the use or benefit of the educational institution, we recommend that guidance should follow the legislative history's approach that, in general, only income and assets earmarked or restricted for the educational institution should be attributed to it. Assets or income that are not earmarked or restricted for the educational institution should be presumed not to be attributed to it. This presumption would not apply in a case, for example, of a controlling organization that only controls educational institutions, in which case all of the assets and income of such controlling organization would be allocated among the educational institutions it controls in any reasonable manner, which would include historical percentages of support.

c. Unrelated Organizations

Guidance should confirm that the assets and income of organizations that are not related to the institution within the meaning of Section 4968(d)(2) would not count either for purposes of determining the amount of assets an institution has or the income subject to the excise tax. For example, assume a private foundation not related to a school provides grants and other distributions to the school (but would not be classified as a supporting organization). The assets and income of such foundation would not be counted for Section 4968 purposes.

Similar questions arise over the treatment of trusts not controlled by the institution, but where the institution is a primary beneficiary. Based on the statute, if such a trust is not a related organization under Section 4968(d)(2), its assets and income should not factor in the determination of the Section 4968 excise tax.

4. Determination of the Section 4968 Tax

Section 4968(c) provides that net investment income will be determined under rules similar to those of Section 4940(c), which defines net investment income for private foundations. As a threshold matter, Treasury and the IRS should consider giving guidance on what form or

schedule this tax will be reported on. Reporting possibly could be on a separate schedule to Form 990, similar to the reporting of the Section 4940 tax on Form 990PF. In the alternative, the Section 4968 tax could be reported on a separate return, similar to Form 990-T for reporting UBIT.

Section 4940 imposes a 1% or 2% tax on the annual net investment income of private foundations.¹¹⁹ “Net investment income” is defined by Section 4940(c)(1) as the amount by which the sum of gross investment income plus capital gain net income exceeds allowable deductions.¹²⁰ Thus, in order for any of a foundation’s income to be subject to tax under Section 4940, it must be included within the definition of gross investment income. For tax years beginning prior to August 18, 2006, “gross investment income” was defined as the gross amount of income from interest, dividends, rents, payments with respect to certain securities loans and royalties (except to the extent included in calculating any unrelated business income tax).¹²¹ In 2006, Congress amended Section 4940 and for tax years beginning after August 18, 2006, “gross investment income” is defined to include “income from sources similar to those” enumerated in the statute.

The Section 4940 Treasury regulations¹²² define “gross investment income” as follows:

...[t]he gross amounts of income from interest, dividends, rents, and royalties (including overriding royalties) received by a private foundation from all sources, but does not include such income to the extent included in computing the tax imposed by section 511. Under this definition, interest, dividends, rents, and royalties derived from assets devoted to charitable activities are includible in gross income. Therefore, for example, interest received on a student loan would be includible in the gross investment income of

¹¹⁹Section 4940(a).

¹²⁰Net investment income is determined under the general taxation principles of Subtitle A, except to the extent that these principles are inconsistent with Section 4940. Section 4940(c)(1).

¹²¹Section 4940(c)(2).

¹²²These regulations defining “gross investment income” have not been amended in response to the 2006 changes to Section 4940.

a private foundation making such loan. For purposes of paragraph (c) of this section, gross investment income also includes the items of investment income described in §1.512(b)-1(a).¹²³

In calculating the new Section 4968 1.4% excise tax, several interpretive issues arise. First, is the income from assets used directly in carrying out the institution's exempt purposes subject to the new excise tax? Based on Section 4940(c) and the Regulations issued thereunder, guidance should provide that the answer is yes. The Section 4940 regulations make clear that interest, dividends, rents and royalties derived from assets devoted to charitable activities are includible in gross investment income. For years after 2006, gross investment income includes "income from sources similar to" those enumerated in the statute. Accordingly, even though assets used in carrying out the institution's exempt purposes may be excluded in determining whether the school has assets of \$500,000 per student, investment-type income from such assets likely should be included in the determination of the Section 4968 tax. For example, interest on student loans, earnings on funds held for specific scholarships or a professor's position, rents from dormitories or faculty housing or royalties from patents created by teachers presumably would be gross investment income.

The inclusion of the foregoing items in gross investment income raises certain issues. Section 4940(c)(3) provides that in determining net investment income, there shall be allowed as a deduction all ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation or maintenance of property held for the production of such income. Presumably, where assets such as dormitories or faculty housing run at a tax loss (possibly as a result of subsidiaries by the institution or not charging fair market rent), such loss will reduce the net investment income from other assets.

¹²³Treas. Reg. § 53.4940-1(d)(1).

In this regard, Section 4968 requires that net investment income be determined under “rules similar to,” but not necessarily identical to, the rules of Section 4940(c). Consideration could be given to interpreting Section 4968 to carve out from gross investment income amounts from exempt use assets that are not held for investment purposes and anticipated to produce net losses. For example, consider dormitories and faculty housing. There are several possible approaches to this situation. First, the income from assets used in the exempt activity, such as rent from dormitories, could be included in investment income and all of the expenses should be deducted and that would reduce net investment income as there is almost certainly a loss here. Second, the income from the use of those assets could be excluded and the expenses would also be excluded. This seems to be the best answer, although perhaps not so easily reached under the statute. Third, the income could be included, and expenses included but only to the extent they offset the income. This third option could also be expanded to encompass a special rule that would prevent an educational institution from using losses from charitable use assets that are also investment assets to generate losses that can be used to offset income.

On the other hand, income from a scholarship fund, the assets of which are excluded in making the \$500,000 of assets per student determination, would be subject to the tax.

Further, guidance should provide that activities or assets that generate income that has not traditionally been considered investment income should not be included in gross investment income. Section 4940(c)(2) provides that “the term ‘gross investment income’ means the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties” as well as “income from sources similar to” those enumerated, but not including any UBTI. Guidance should confirm that tuition or museum or gym admission fees or income from a related business, such as a campus bookstore, should not

be included in gross investment income.

5. Possible Anti-abuse Rule

We have considered whether guidance should include anti-abuse rules. For example, assume an educational institution has 800 students. Could such institution become two education institutions (for example, a school for women and a school for men) so that each educational institution has only 400 students and falls outside of the definition of applicable educational institution? In the alternative, could an educational institution start an online degree or certificate program and enroll enough new students to dilute its per student investment assets to below \$500,000 per student and avoid the Section 4968 tax? If the institution offers online courses for a nominal or no charge without restrictions, so-called massive open online courses or MOOCs, should students that take such courses be treated as students of the institution for purposes of determining the \$500,000 in assets per student?¹²⁴ Treasury and the IRS should consider guidance that provides that only students in a degree program who are tuition-paying (or part of a program alongside of tuition-paying students) be included in determining how many students the endowment would be divided among for determining whether the institution has over \$500,000 per student. While potentially abusive, such actions have real, non-tax consequences. Until real cases of abuse come to the IRS's attention, we recommend that guidance not include an anti-abuse rule.

* * * *

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this Report, please feel free to contact us and we will be glad to discuss or assist in any way.

¹²⁴We note the statute does not define student.